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THE STRONG DOLLAR: IMPACT ON DOMESTIC CREDIT AND INTEREST RATES

HEARING

BEFORE THE

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

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THE STRONG DOLLAR: IMPACT ON DOMESTIC CREDIT AND INTEREST RATES

THURSDAY, NOVEMBER 7, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Present: Chairman Fauntroy; Representatives Barnard, Carper, McCollum, and Ridge.

Chairman FAUNTROY. The subcommittee will come to order.

Today the subcommittee will examine the relationships between the international value of the dollar, domestic credit, and interest rates; especially in light of the increased need for foreign capital to finance the gap between consumption and production in the United States.

The rise of the dollar by some 40 to 60 percent since 1980 has resulted in major changes in the real and financial markets both in the United States and abroad. The rise in the dollar has many causes, including the budget deficits, high real interest rates, the safe haven effect, and differential rates of economic growth throughout the world.

The interest of those concerned with domestic finance and credit has intensified in light of the recent intervention by the G–5 countries—France, England, West Germany, Japan, and the United States—particularly since a lowering of the dollar could place upward pressure on both interest rates and inflation with untoward effects for the continued economic growth we are experiencing.

If the dollar falls precipitously, we want to know whether the Federal Reserve would increase interest rates in order to offset increases in the inflation rate or to maintain adequate foreign financing to cover the gap between production and consumption in the United States. What would the likely consequences of increased interest rates be on the rate of domestic economic growth?

In addition, the following questions must be addressed in regard to the recent intervention by the G–5 countries. Does the intervention narrow the options of the Federal Reserve in the conduct of monetary policy? Will sterilization of the currency place additional restrictions on the availability of domestic credit? If the net effect of the interventions proves to be unsuccessful, what is the likeli-

hood of a net loss of funds to the Federal Reserve and thus to the Treasury?

The subcommittee is additionally interested in testimony addressing the current strength of the dollar. What standard should be used in determining whether the dollar is too strong? Should the United States maintain a strong dollar so as to attract funds from other countries? Is this a feasible strategy? Is it a wise strategy? More importantly, is intervention being promoted in lieu of substantial budget deficit reduction and an industrial policy which would promote modernization of plant and equipment for effective competition.

That brings me to the final issue we will address at this hearing. Should the value of the currency be fixed within specific parameters? Can this even be done? What alternatives exist for meeting domestic credit demands and the trade deficits? Have we entered a new and different kind of era which compels us to manage our economy through interest rate manipulation and austerity programs which used to be known only to people abroad?

These are tough questions, and they portend answers we will not like. Our responsibilities, however, require us to consider them and to fashion the best policy possible.

At this point in the record I will insert the subcommittee's news release, notice of hearing, and letters of invitation to the witnesses.

[The materials follow:]

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA, CHAIRMAN
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U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

NEWS NEWS NEWS NEWS NEWS

FOR IMMEDIATE RELEASE
TUESDAY, OCTOBER 29, 1985

CONTACT: HOWARD LEE
JOHN BALDER
202-226-7315

SUBCOMMITTEE TO ASSESS RELATION BETWEEN VALUE OF DOLLAR AND DOMESTIC CREDIT AND INTEREST RATES

Will Examine Whether the Fed Might Raise Interest Rates to Attract Foreign Capital to Finance the Government Deficits

(Washington, D.C.) The Subcommittee on Domestic Monetary Policy will seek to determine whether and under what circumstances the Federal Reserve might be compelled to raise interest rates to maintain foreign investment for U.S. debt financing. The hearings will be held at 10:00 A.M. on THURSDAY, NOVEMBER 7, 1985 IN ROOM 2128 of the RAYBURN HOUSE OFFICE BUILDING.

In a letter to potential witnesses, Subcommittee Chairman Walter E. Fauntroy said the Subcommittee is especially interested in understanding the effect on interest rates and inflation of the recent intervention by the G-5 countries and any alternative suggestions witnesses might proffer as to alternative methods of addressing the "strength" of the dollar.

Fauntroy went on to say that the Subcommittee is also interested in whether the intervention will lead to an adequate decline in the value of the dollar, and if not, the likelihood of a net loss to the Federal Reserve and thus its income transfer to the Treasury. Excess earnings to the Federal Reserve, which are transferred to the Treasury, totaled $16 billion last year.

In announcing the hearings, Fauntroy said that while the efforts of the nations comprising the G-5 countries (France, Germany, Japan, the United Kingdom, and the United States) have the potential for substantial success in both controlling the dollar and reducing the current account deficits, there is the risk both of precipitating a significant fall in the dollar and of permitting foreign exchange operations to dominate domestic monetary policy in an untoward fashion.

Whatever we need to do to manage foreign exchange rates should be undertaken with a view of assuring orderly markets in both our international and domestic transactions. The net effect of allowing interest rates to rise in the United States might more than offset the benefits to be achieved from a lower dollar. In addition, foreign exchange operations, said Fauntroy, cannot substitute for sufficient self-stimulation of those countries with weak currencies relative to the United States. Just as they cannot expect to grow solely by exporting to the United States, neither can they expect us to assume a disproportionate burden in exchange rate management.

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA, CHAIRMAN
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U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

November 4, 1985

NOTICE OF SUBCOMMITTEE HEARING AND WITNESS LIST

To : Members, Subcommittee on Domestic Monetary Policy
Members, Committee on Banking, Finance and Urban Affairs

From : Walter E. Fauntroy
Chairman, Subcommittee on Domestic Monetary Policy

Re : Hearings on "The Strong Dollar: Assessment of the Relationship Between the Value of the Dollar and Domestic Credit and Interest Rates

THURSDAY

NOVEMBER 7

2128 RAYBURN

10:00 A.M.

The Subcommittee on Domestic Monetary Policy will meet on Thursday, November 7, 1985, at 10:00 a.m. in 2128 Rayburn House Office Building to receive testimony from economists, representatives of the financial market, the Administration and the Federal Reserve concerning the relationship between the value of the dollar, domestic credit and interest rates.

The Subcommittee is especially interested in understanding the effect on interest rates and inflation of the recent intervention by the G-5 countries and under what circumstances, if any, the Federal Reserve might be obliged to encourage a rise in interest rates in order to maintain adequate foreign investment to finance the U.S. budget deficit. The Subcommittee is also interested in whether the interventions will prove adequate and if not, the likelihood of a net loss of funds to the Federal Reserve's portfolio and thus to its income transfers to the Treasury.

Other questions which the Subcommittee has asked witnesses to consider include whether interventions should be accompanied by sterilization of the currency; the credit impact on the availability of domestic credit; whether intervention is being promoted in lieu of substantial budget deficit reductions and in lieu of industrial policies which would promote modernization and competition; and whether or not there should be a fixed or flat exchange rate policy.

WITNESSES

Mr. Stephen H. Axilrod, Staff Director for Monetary and Financial Policy, Federal Reserve Board
Dr. Ralph Bryant, Brookings Institute
Dr. Jeff Frankel, Associate Professor, University of California at Berkeley
Dr. Mieczyslaw Karczmar, European American Bank
Mr. Kenneth Rempell, Merrill Lynch
Dr. T. E. "Rick" Kilcollin, Senior Vice-President/Chief Economist, Chicago Mercantile Exchange

LETTER OF INVITATION TO THE FEDERAL RESERVE

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA
CHAIRMAN
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U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

Dear Paul:

On Thursday, November 7, 1985, the Subcommittee on Domestic Monetary Policy will take testimony assessing the relation between the value of the dollar, domestic credit and interest rates. I would very much like for you or your designee to testify on the dollar at this hearing.

The Subcommittee is especially interested in understanding the effect on interest rates and inflation of the recent intervention by the G-5 countries and under what circumstances, if any, the Federal Reserve might be obliged to encourage a rise in interest rates in order to maintain adequate foreign investment to finance the U.S. budget deficit. The Subcommittee is also interested in whether the intervention will prove adequate and if not, the likelihood of a net loss of funds to the Federal Reserve's portfolio and thus to its income transfers to the Treasury.

While the Subcommittee hopes that your assessment will be in terms of the impact of a fall in the dollar on interest rates, inflation and the availability of domestic credit, you should feel free to raise other considerations that analysts of the financial economy should consider.

Additionally, the Subcommittee would welcome your views on the current valuation of the dollar and the intervention by responding to the following issues:

- Is the dollar too strong? Can you estimate the relation between a specific fall in the dollar and the diminution of the availability of domestic credit? Please explain the methodology used in arriving at your conclusions.

- Should the response of the G-5 countries be manifest through intervention in the international currency markets? Should intervention be accompanied by sterilization of the currency? If so, will the result necessarily restrict the availability of domestic credit?

- Is intervention being promoted in lieu of substantial budget deficit reductions and an industrial policy which would modernize plant and equipment for effective competition?

- Should the currency be fixed within specific parameters? What other types of response are possible?

- Finally, is the need for reliance on foreign capital an adequate reason to maintain or permit the present valuation of the dollar or should alternatives be sought? What might the nature of these alternatives be?

I would like for you or your designee to testify on these issues on THURSDAY, NOVEMBER 7, 1985, at 10:00 A.M. in room 2128 of the Rayburn House Office Building in Washington, D.C. Committee rules require that 100 copies of your written testimony be made available to the Subcommittee the day before the hearing for the use of the Subcommittee Members and staff, and for distribution to members of the press and the public who may be in attendance at the hearing. However, the Subcommittee Chairman may waive or modify this requirement if circumstances make it difficult for you to comply. If you have any questions about this or any other aspect of your testimony, please feel free to contact Howard Lee or John Balder of the Subcommittee staff at 202-226-7315.

I look forward to your testimony on Thursday, November 7, 1985, and thank you in advance for your assistance to the Subcommittee.

Sincerely yours,

Walter E. Fauntroy
Subcommittee Chairman

LETTER OF INVITATION TO OTHER WITNESSES

WALTER E. FAUNTROY, DISTRICT OF COLUMBIA
CHAIRMAN
STEPHEN L. NEAL, NORTH CAROLINA
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COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

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While the Subcommittee hopes that your assessment will be in terms of the impact of a fall in the dollar on interest rates, inflation and the availability of domestic credit, you should feel free to raise other considerations that analysts of the financial economy should consider.

Additionally, the Subcommittee would welcome your views on the current valuation of the dollar and the intervention by responding to the following issues:

** Is the dollar too strong? Can you estimate the relation between a specific fall in the dollar and the diminution of the availability of domestic credit? Please explain the methodology used in arriving at your conclusions.

** Should the response of the G-5 countries be manifest through intervention in the international currency markets? Should intervention be accompanied by sterilization of the currency? If so, will the result necessarily restrict the availability of domestic credit?

** Is intervention being promoted in lieu of substantial budget deficit reductions and an industrial policy which would modernize plant and equipment for effective competition?

** Should the currency be fixed within specific parameters? What other types of response are possible?

** Finally, is the need for reliance on foreign capital an adequate reason to maintain or permit the present valuation of the dollar or should alternatives be sought? What might the nature of these alternatives be?

I would like for you to testify on these issues on THURSDAY, NOVEMBER 7, 1985, at 10:00 A.M. in room 2128 of the Rayburn House Office Building in Washington, D.C. Committee rules require that 100 copies of your written testimony be made available to the Subcommittee the day before the hearing for the use of the Subcommittee Members and staff, and for distribution to members of the press and the public who may be in attendance at the hearing. However, the Subcommittee Chairman may waive or modify this requirement if circumstances make it difficult for you to comply. If you have any questions about this or any other aspect of your testimony, please feel free to contact Howard Lee of the Subcommittee staff at 202-226-7315.

I look forward to your testimony on Thursday, November 7, 1985, and thank you in advance for your assistance to the Subcommittee.

Sincerely yours,

Walter E. Fauntroy
Subcommittee Chairman

Chairman FAUNTROY. Appearing from the Federal Reserve is Stephen H. Axilrod, Staff Director for Monetary and Financial Policy, accompanied by Edwin Truman, Director of the Division of International Finance.

In addition, we are honored to have with us Dr. Ralph Bryant with the Brookings Institute; Dr. Jeff Frankel, associate professor at the University of California at Berkeley; Dr. Mieczyslaw Karczmar, with the European American Bank; Mr. Ken Rempell, with Merrill Lynch; and T.E. Kilcollin, senior vice president and chief economist with the Chicago Mercantile Exchange.

I welcome each of you. Before we commence hearing your testimony, I will yield to my distinguished colleague, Mr. McCollum, for such remarks he may wish to make at this time.

Mr. MCCOLLUM. Thank you, Mr. Chairman, and I want to thank you for holding these hearings, and I want to welcome our distinguished witnesses to the hearing today. A great deal has been said over the past few years about the value of the dollar and in recent months, there have been those who traded. So I look forward to hearing today from the witnesses regarding the intervention recently that was decided upon by the G-5 countries.

As the chairman has indicated, we have a number of areas that have interested this committee at this time. Of particular interest to me is whether that intervention was truly necessary, what the effects are going to be, both short term and long term, and what other problems may or may not arise as a result of that intervention.

There are many other questions that have been raised in the chairman's opening statement, and I am sure, from looking over briefly some of the witness' testimony, there are others that are going to be explored still beyond that today.

So all in all, it looks like an interesting and important hearing for us. Thank you, Mr. Chairman.

[The opening statement of Congressman McCollum follows:]

OPENING STATEMENT OF HON. BILL MCCOLLUM

Mr. Chairman, I want to thank you for holding these hearings today. I also want to welcome the witnesses today.

We have heard a great deal in recent months about the over valued dollar. It has been attributed with from 50 to 80 percent of trade imbalance and is credited to some extent for the low inflation rates that we have seen in the past year. The decision on the part of the G-5 countries recently to intervene in the foreign exchange markets raises several questions in my mind as to was this necessary and what are the long term effects of this intervention.

In the past we reserved the use of intervention for cases where speculation had driven one of the currencies out of line. Now the dollar is being driven by speculation but by fundamental differences in the economies of the currency's countries. In the United States the problem driving the dollar up is the budget deficit. Borrowing to cover the debt that has resulted from deficit spending has driven real interest rates to historically high level and has maintained these high real interest rates at this level for an unprecedented length of time. There are many other contributing factors to the dollars strength both domestically and abroad, but are we using this intervention to relieve the pressure of our own run away spending and thus further put off real action to curb deficit spending? I certainly hope not. It does seem to me that we are curing a symptom not the disease.

The other question that this intervention begs is that of its effect on the domestic economy. Inflation is far from being defeated. We should not forget that the inflation rate was four percent when wage and price controls were instituted in the early 70's. Will this round of coordinated intervention result in higher inflation? In and of

itself alone probably not; but in combination with monetary growth well above target and the hoped for lessening of the impact of imports, the fear is real. This hearing was designed to shed some light on these concerns.

Once again I want to thank the chairman of the subcommittee for holding these important and timely hearings.

Chairman FAUNTROY. Thank you, Mr. McCollum.

We now call our first witness, Mr. Stephen Axilrod. Mr. Axilrod, it is a pleasure to have you open our hearings. We have had an opportunity to read your testimony. You may proceed in whatever manner you choose.

STATEMENT OF STEPHEN H. AXILROD, STAFF DIRECTOR FOR MONETARY AND FINANCIAL POLICY, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ACCOMPANIED BY EDWIN TRUMAN

Mr. AXILROD. Thank you, Mr. Chairman. I am pleased to appear before you this morning to discuss the exchange markets for the dollar in the aftermath of the G–5 meeting on September 22, and also the relationship among exchange market conditions and domestic economic and credit developments.

At the September meeting, finance ministers and central bank governors of the G–5 countries emphasized the interrelationships among our economies, the importance of mutually consistent policies in achieving sustained growth and dealing with economic imbalances, and the role played by exchange rates. They indicated that, in their judgment, the then-current constellation of exchange rates did not fully reflect the underlying movement toward convergence in our economies—in terms of both satisfactory real growth and progress in reducing inflation. Intentions were reaffirmed to implement policies that would lead to better balance within and among our individual countries. Finally, a willingness to intervene more actively in exchange markets when to do so would be helpful was implied, and indeed since then, a sizable amount of coordinated intervention has been undertaken.

Before addressing some of the specific issues which this hearing is attempting to explore, let me provide some perspective on the economic conditions in the United States that were background to, and which may benefit from, the recent exchange market initiative.

Our economy has been performing quite strongly overall since the 1982 recession in terms of economic growth, new jobs created, and reduced inflationary pressures. However, our economic growth slowed appreciably after the middle of last year. Some slowing was, of course, natural as the economy reached higher levels of resource utilization, but the extent of our slowing also seemed related to imbalances in the economy traceable in part to the very high level of the dollar on exchange markets.

The rate of increase in domestic output—which generates the income we need in the end to sustain spending—has been only 2.25 percent over the past 15 months. Meanwhile, domestic demand in real terms has continued to rise at a rate of more than 3.25 percent a year, and final demands for consumption, for government outlays, and for investment and housing have been running even

higher relative to output, growing by about 4.25 percent per year over the period.

The difference between growth in the U.S. final demand and growth in U.S. output, apart from slowing of inventory accumulation, is a reflection of our risking trade and current account deficits. In effect, while we have created more than 9-million jobs in 3 years within the United States, we have also turned to importing—net—well over 3 percent of our gross national product. The very favorable terms on which goods can be obtained from abroad, given the exchange rate, have been an important contributory factor along with relatively slow domestic growth of other leading countries.

The rise in imports has brought with it some benefits along with its costs. One clear gain is the associated reduction in inflationary pressures in the United States. It is not just the price of imported goods that has declined as the value of the dollar has risen. There are also important indirect effects. Bottlenecks in some sectors have been avoided. Firms using imported goods in their production processes have seen their costs rise less rapidly, or decline, and have passed these cost savings on to consumers. Some other firms, who may not use imported goods but who must compete with imported goods, have been induced to invest, to innovate, and to modernize their production to preserve their markets, with potential lasting benefit to the U.S. economy in terms of efficiency and enhanced productivity.

In addition, the rise in U.S. imports has created export opportunities in other countries and, thus, has played a role in fostering growth abroad. This includes not only industrial countries, but also, of course, some of the heavily indebted countries of Latin America and elsewhere. In the latter, growth of exports has facilitated the lengthy and painful adjustment process that they have undertaken.

However, with U.S. trade and current account deficits, each approaching $130 billion, strains are showing. Under the pressure of rising imports, manufacturing activity as a whole has been stagnant for a year, and some industries are losing jobs. This has contributed directly to the slowing of output growth in this country and seems to be encouraging plans to put more future investment abroad. Mining activity in the United States is also at a low ebb, and many individual farmers, with exports diminishing and prices low, face very difficult financial circumstances. And as you are well aware, the strongest tide of protectionist pressures is running since the 1930's.

The U.S. trade and current account deficits have now reached levels that cannot be sustained indefinitely, threatening to undercut our stability and implying less stimulus to others. We have now become a net debtor internationally, and that position will continue to deepen so long as our current account is in deficit, requiring net inflows of capital from abroad to finance it. Confidence in the U.S. economy remains generally strong, so that we can expect a willingness to place sizable funds here for a time, but obviously we cannot afford to rely excessively and indefinitely on foreign saving to help sustain our domestic spending.

The net inflow of foreign capital, which is inextricably tied to the trade deficit, has been crucial to filling the gap between our limited domestic saving and the demands on that saving from expanding Federal budget deficits and private investment outlays for plant, equipment and housing. Without a rising net inflow of foreign funds in recent years, domestic interest rates, which have in any event been historically high, would have been still higher and added pressure exerted on interest-sensitive sectors of the economy. But one cannot prudently expect foreign funds to provide a permanent basis for balancing demand and supply in domestic credit markets.

Over the past year, there has been some abatement of interest rate pressures here, along with the continued availability of foreign saving, that also reflected market response to our continued good wage and price performance and some diminution of private credit demands this year as growth in economic activity has slowed. In addition, monetary growth—measured by M1—has been relatively large.

In essence, the Federal Reserve accommodated to the increased demand for money as interest rates dropped because, among other factors, the economic expansion was tending to slow—with that slowing partly because of the drag of high exchange rates on certain key sectors of the economy. At the same time, the exceptional strength of the dollar suggested the inflationary potential for the time being would be limited.

Sustained, healthy economic growth here requires more balanced participation of all our economic sectors. Appreciation of some important foreign currencies relative to the dollar will contribute to that. It will help our export industries, including agriculture, and provide greater opportunities for industries sensitive to import competition.

The exchange value of the dollar has dropped about 8 percent on a trade-weighted basis since the G–5 meeting and is now about 22 percent below its February peak. Some progress has, thus, been made toward easing undue competitive pressures on U.S. industry. While there are always lags and uncertainties in economic processes, the drop so far seems unlikely in itself to generate strong inflationary pressures, in part because it probably represents to some extent an unwinding of speculative pressures around the exchange market peak that had not yet been reflected in prices of traded goods, but also because it is occurring at a time when some excess capacity exists, economic growth is relatively slow, and inflationary expectations here are relatively subdued.

I might also add at this point that exchange market intervention does not necessarily have expansive or restrictive effects on domestic credit availability. When the Federal Reserve acquires foreign currencies, that act will create bank reserves. However, those effects will be offset by sales—or fewer purchased—of Government securities for the open market account, depending upon the supply of reserves, or degree of reserve pressures, the FOMC deems appropriate. In reaching that judgment, the committee may take account of exchange market conditions, but the judgment is not driven by the presence or absence of intervention.

Whether purchases of foreign currencies have any direct effect on the amount of income transferred to the Treasury from the Federal Reserve depends on relative interest rates here and abroad and the behavior of exchange rates. Interest rates are now generally lower in key foreign countries than here, tending to reduce Federal Reserve earnings at the margin as foreign currencies are acquired. However, even that small reduction would be offset, and earnings sustained, should the value of the foreign currencies acquired increase through an appreciation in their market value. Whatever the net effect, it would be very small absolutely and relative to Treasury receipts.

While some decline in the dollar's external value from the extraordinarily high level of the past year may have been necessary or desirable, I should point out lasting benefits depend upon other policies and conditions. Too large or too abrupt a decline could in today's circumstances have adverse consequences. Our deficits on trade and current account cannot be expected to drop off quickly. For one thing, it simply takes time to make the large adjustments in use of our manpower and plant capacity required of a significant real improvement in our trade balance. Should the dollar drop too sharply, the consequent increased foreign demand for our exports and increased domestic demand for goods that compete with imports probably could not be readily matched by a prompt, balancing readjustment of domestic resource use.

Depending in part on how fully utilized are our plant and manpower resources, considerable upward wage and price pressures could result from efforts to achieve these real adjustments quickly, given normal rigidities and response lags in the economy. Such a development, together with the direct effect of a sharp depreciation on import prices, would seriously jeopardize the progress we have made in reducing inflation and raise new questions about interest rates.

If weaknesses in the dollar reflects a greatly reduced willingness on the part of the rest of the world to accumulate net claims on the United States—while we were at the same time still dependent on such funds—interest rates here would come under additional upward pressure. The upward pressure would be generated out of market forces as a diminishing supply of credit at old interest rates has to be balanced against continued demands. A rise in interest rates will bring balance both by increasing the supply and diminishing the demand.

In many ways such an outcome would be counterproductive. Many domestic and foreign borrowers are heavily burdened with debt and cannot afford greater real costs. In addition, if rising interest rates led to greater discouragement of private investment outlays here, they would be undermining the principal source of our long-term economic growth and further eroding our ability to regain international competitiveness.

The adjustment problems I have described would be greatly alleviated by meaningful and assured progress in reducing our high Federal budget deficits. The budget deficit not only looms large relative to our own domestic propensity to save but it also represents a significant drain on world saving. As it is reduced, it would directly alleviate pressures on credit markets, would diminish our de-

pendence on foreign saving, and would free up domestic resources that could be shifted in a more orderly fashion to export and import-sensitive industries.

That is the reason that the G–5 ministers and governors, and much of the subsequent discussion, have rightly emphasized the need for more fundamental macroeconomic policy adjustments here and abroad. The Federal Reserve takes as one point of departure the fact that maintenance of underlying confidence in the dollar is dependent on the perception that U.S. monetary policy will remain responsible, in the sense that it will aim to accommodate sustained growth of real economic activity with continued progress toward price stability. Intervention and exchange rate changes are no substitute for sound underlying policies.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Axilrod follows:]

Testimony of

Stephen H. Axilrod

Staff Director for Monetary and Financial Policy

Board of Governors of the Federal Reserve System

I am pleased to appear before you this morning to discuss the exchange markets for the dollar in the aftermath of the G-5 meeting on September 22 and also the relationship among exchange market conditions and domestic economic and credit developments. At the September meeting, finance ministers and central bank governors of the G-5 countries emphasized the interrelationships among our economies, the importance of mutually consistent policies in achieving sustained growth and dealing with economic imbalances, and the role played by exchange rates. They indicated that, in their judgment, the then current constellation of exchange rates did not fully reflect the underlying movement toward convergence in our economies -- in terms of both satisfactory real growth and progress in reducing inflation. Intentions were reaffirmed to implement policies that would lead to better balance within and among our individual countries. Finally, a willingness to intervene more actively in exchange markets when "to do so would be helpful" was implied, and indeed since then a sizable amount of coordinated intervention has been undertaken.

Before addressing some of the specific issues which this hearing is attempting to explore, let me provide some perspective on the economic conditions in the U.S. that were background to, and which may benefit from, the recent exchange market initiative.

Our economy has been performing quite strongly, over-all, since the 1982 recession in terms of economic growth, new jobs created, and reduced inflationary pressures. However, our economic growth slowed appreciably after the middle of last year. Some slowing was of course natural as the economy reached higher levels of resource utilization,

but the extent of our slowing also seemed related to imbalances in the economy traceable in part to the very high level of the dollar on exchange markets.

The rate of increase in domestic output — which generates the income we need in the end to sustain spending — has been only 2-1/4 percent over the past 15 months. Meanwhile, domestic demand in real terms has continued to rise at a rate of more than 3-1/4 percent a year, and final demands for consumption, for government outlays, and for investment and housing have been running even higher relative to output, growing by about 4-1/2 percent per year over the period.

The difference between growth in U.S. final demand and growth in U.S. output, apart from slowing of inventory accumulation, is a reflection of our rising trade and current account deficits. In effect, while we have created more than 9 million jobs in three years within the United States, we have also turned to importing (net) well over 3 percent of our gross national product. The very favorable terms on which goods can be obtained from abroad, given the exchange rate, have been an important contributory factor along with relatively slow domestic growth of other leading countries.

The rise in imports has brought with it some benefits along with its costs. One clear gain is the associated reduction in inflationary pressures in the United States. It is not just that the price of imported goods has declined as the value of the dollar has risen. There are also important indirect effects. Bottlenecks in some sectors have been avoided. Firms using imported goods in their production processes have seen their costs rise less rapidly, or decline, and have

passed these cost savings on to consumers. Some other firms, who may not use imported goods but who must compete with imported goods, have been induced to invest, to innovate, and to modernize their production to preserve their markets, with potential lasting benefit to the U.S. economy in terms of efficiency and enhanced productivity.

In addition, the rise in U.S. imports has created export opportunities in other countries and thus has played a role in fostering growth abroad. This includes not only industrial countries, but also of course some of the heavily indebted countries of Latin America and elsewhere. In the latter, growth of exports has facilitated the lengthy and painful adjustment process that they have undertaken.

However, with U.S. trade and current account deficits each approaching $130 billion, strains are showing. Under the pressure of rising imports, manufacturing activity as a whole has been stagnant for a year, and some industries are losing jobs. This has contributed directly to the slowing of output growth in this country, and seems to be encouraging plans to put more future investment abroad. Mining activity in the U.S. is also at a low ebb, and many individual farmers, with exports diminishing and prices low, face very difficult financial circumstances. And, as you are well aware, the strongest tide of protectionist pressures is running since the 1930s.

The U.S. trade and current account deficits have now reached levels that cannot be sustained indefinitely, threatening to undercut our stability and implying less stimulus to others. We have now become a net debtor internationally, and that position will continue to deepen so long as our current account is in deficit, requiring net inflows of

capital from abroad to finance it. Confidence in the U.S. economy remains generally strong, so that we can expect a willingness to place sizable funds here for a time, but obviously we cannot afford to rely excessively and indefinitely on foreign saving to help sustain our domestic spending.

The net inflow of foreign capital, which is inextricably tied to the trade deficit, has been crucial to filling the gap between our limited domestic saving and the demands on that saving from expanding federal budget deficits and private investment outlays for plant, equipment, and housing. Without a rising net inflow of foreign funds in recent years, domestic interest rates, which have in any event been historically high, would have been still higher and added pressure exerted on interest-sensitive sectors of the economy. But one cannot prudently expect foreign funds to provide a permanent basis for balancing demand and supply in domestic credit markets.

Over the past year there has been some abatement of interest rate pressures here. Along with the continued availability of foreign saving, that also reflected market response to our continued good wage and price performance and some diminution of private credit demands this year as growth in economic activity has slowed. In addition monetary growth -- measured by M1 -- has been relatively large. In essence, the Federal Reserve accommodated to the increased demand for money as interest rates dropped because, among other factors, the economic expansion was tending to slow -- with that slowing partly because of the drag of high exchange rates on certain key sectors of the economy. At the same time, the exceptional strength of the dollar suggested the inflationary potential for the time being would be limited.

Sustained, healthy economic growth here requires more balanced participation of all our economic sectors. Appreciation of some important foreign currencies relative to the dollar will contribute to that. It will help our export industries, including agriculture, and provide greater opportunities for industries sensitive to import competition.

The exchange value of the dollar has dropped about 8 percent on a trade-weighted basis since the G-5 meeting and is now about 22 percent below its February peak. Some progress has thus been made toward easing undue competitive pressures on U.S. industry. While there are always lags and uncertainties in economic processes, the drop so far seems unlikely in itself to generate strong inflationary pressures, in part because it probably represents to some extent an unwinding of speculative pressures around the exchange market peak that had not yet been reflected in prices of traded goods but also because it is occurring at a time when some excess capacity exists, economic growth is relatively slow, and inflationary expectations here are relatively subdued.

I might also add at this point that exchange market intervention does not necessarily have expansive or restrictive effects on domestic credit availability. When the Federal Reserve acquires foreign currencies, that act will create bank reserves. However, those effects will be offset by sales (or fewer purchases) of government securities for the Open Market account, depending upon the supply of reserves, or degree of reserve pressures, the FOMC deems appropriate. In reaching that judgment, the Committee may take account of exchange market conditions, but the judgment is not driven by the presence or absence of intervention.

Whether purchases of foreign currencies have any direct effect on the amount of income transferred to the Treasury from the Federal Reserve depends on relative interest rates here and abroad and the behavior of exchange rates. Interest rates are now generally lower in key foreign countries than here, tending to reduce Federal Reserve earnings at the margin as foreign currencies are acquired. However, even that small reduction would be offset, and earnings sustained, should the value of the foreign currencies acquired increase through an appreciation in their market value. Whatever the net effect, it would be very small absolutely and relative to Treasury receipts.

While some decline in the dollar's external value from the extraordinarily high level of the past year may have been necessary or desirable, I should point out lasting benefits depend upon other policies and conditions. Too large or too abrupt a decline could in today's circumstances have adverse consequences. Our deficits on trade and current account cannot be expected to drop off quickly. For one thing, it simply takes time to make the large adjustments in use of our manpower and plant capacity required of a significant real improvement in our trade balance. Should the dollar drop too sharply, the consequent increased foreign demand for our exports and increased domestic demand for goods that compete with imports probably could not be readily matched by a prompt, balancing readjustment of domestic resource use. Depending in part on how fully utilized are our plant and manpower resources, considerable upward wage and price pressures could result from efforts to achieve these real adjustments quickly, given normal rigidities and response lags in the economy. Such a development,

together with the direct effect of a sharp depreciation on import prices, would seriously jeopardize the progress we have made in reducing inflation and raise new questions about interest rates.

If weakness in the dollar reflects a greatly reduced willingness on the part of the rest of the world to accumulate net claims on the United States -- while we were at the same time still dependent on such funds -- interest rates here would come under additional upward pressure. The upward pressure would be generated out of market forces as a diminishing supply of credit at old interest rates has to be balanced against continued demands. A rise in interest rates will bring balance both by increasing the supply and diminishing the demand.

In many ways such an outcome would be counterproductive. Many domestic and foreign borrowers are heavily burdened with debt, and cannot afford greater real costs. In addition, if rising interest rates led to greater discouragement of private investment outlays here, they would be undermining the principal source of our long-term economic growth and further eroding our ability to regain international competitiveness.

The adjustment problems I have described would be greatly alleviated by meaningful and assured progress in reducing our high federal budget deficits. The budget deficit not only looms large relative to our own domestic propensity to save but it also represents a significant drain on world saving. As it is reduced it would directly alleviate pressures on credit markets, would diminish our dependence on foreign saving, and would free up domestic resources that could be

shifted in a more orderly fashion to export and import-sensitive industries.

That is the reason that the G-5 ministers and governors, and much of the subsequent discussion, have rightly emphasized the need for more fundamental macro-economic policy adjustments here and abroad. The Federal Reserve takes as one point of departure the fact that maintenance of underlying confidence in the dollar is dependent on the perception that U.S. monetary policy will remain responsible, in the sense that it will aim to accommodate sustained growth of real economic activity with continued progress toward price stability. Intervention, and exchange rate changes, are no substitute for sound underlying policies.

Chairman FAUNTROY. Thank you, Mr. Axilrod.

Chairman Volcker sent me a letter yesterday indicating that the Federal Open Market Committee expects that the growth of the M1 money supply to remain above the target range established in July for the remainder of the year, and that this is acceptable to them. To what extent did FOMC agreement on this growth path reflect international considerations? And, more to the point, how far above the target range will the FOMC tolerate greater growth?

Mr. AXILROD. I think in coming to that view, which was reflected in the chairman's letter to you yesterday, the FOMC took the exchange rate, to the extent it was affecting U.S. activity and prices, into consideration. As I mentioned, it is having a beneficial benefit on prices and probably a sluggish effect on economic activity.

More fundamentally as well within the current context, the velocity of money has been dropping. It has been dropping very sharply and somewhat reminiscent of the drop in 1982 and early 1983. Of course, the economy then was much weaker than it is now. But now, as then, the drop in velocity probably reflects a response to a decline in interest rates—and interest rates are currently down from late last year.

With inflation subdued, the economy very weak, the high dollar dragging the economy, it was felt that an increased demand for money as reflected in the sharp drop in velocity could be accommodated since there were not indications that the money growth was going to produce, at least under current circumstances, substantial inflationary problems.

Chairman FAUNTROY. How long do you believe the United States can rely on foreign savings to help sustain our own domestic spending?

Mr. AXILROD. I think if you had asked a group of economists 2 years ago they would have said not much longer. I remember being in Japan at a conference at that time, and many economists from around the world were saying that it was a cinch that the dollar

would drop sharply. Instead we have had 2 years of a quite strong dollar.

Thus each year of a strong dollar stretches the imagination a bit, but I think the drop in the dollar since February has indicated that to a degree time is running out. But I would hasten to add that we still see reasonable confidence in the dollar abroad, and we do not see any rush out of dollars on the part of foreign investors. So I think with confidence in the economy, we can rely on quite an orderly pattern of adjustment.

Chairman FAUNTROY. Were it not for these foreign inflows, what do you think domestic interest rates might be now? If the dollar were to fall, say 20 percent, so what might be interest rates in this country?

Mr. AXILROD. Well, it is very difficult to say, Mr. Chairman, as I am sure you know; a lot would depend on what was otherwise going on in the economy. For example, if you had a further sharp drop in the dollar in a period when the economy was, say, weak, very weak, even weaker than now, that might very well be absorbed without any substantial evidence of interest rate pressures.

On the other hand, if the economy were much stronger than now, operating with higher levels of capacity, and the dollar were dropping for exogenous reasons, because of a change in attitudes abroad, then, of course, the drop would be more quickly manifested in interest rate pressures.

I don't think there is any doubt—at least in my mind—that interest rates in the past 2 or 3 years have been lower than they otherwise would have been to some degree because of behavior of the dollar, but it is really most difficult to specify what actually would happen to interest rates in the future.

Chairman FAUNTROY. Exchange market intervention does not necessarily have expansive or restrictive effects upon domestic credit availability?

Mr. AXILROD. No. Domestic credit availability depends in large part on the amount of savings generated in our economy and things of that sort. Savings has been running relatively low recently. It also depends at the margin on the amount of bank reserves created through monetary policy, and that, as I tried to indicate, is a separable decision from the exchange market intervention operation.

Chairman FAUNTROY. That, of course, occurs because of sterile intervention. What is the cost of sterile intervention in terms of impact on domestic credit?

Mr. AXILROD. I don't believe there is any in the sense that I think you are using the word, Mr. Chairman. When we acquire foreign currencies, that expands the reserve base, which is our marginal impact on credit. If that expansion of the reserve base was consistent with how monetary policy was tuned at that moment, then it would simply continue that way and the acquisition of foreign currencies would have simply taken the place of acquisitions of domestic securities.

In both cases, the reserve base would have expanded, whether through acquisition of foreign currencies or acquisition of domestic securities. So I don't think that operation per se has any significant effect on domestic credit availability.

Chairman FAUNTROY. My colleague, Mr. Ridge, has arrived, and inasmuch as my time has expired, I will yield to him.

Mr. RIDGE. Thank you, Mr. Chairman. Thank you, Mr. Axilrod.

I do have a few questions, and I would ask unanimous consent, Mr. Chairman, since I will not be able to remain for the entire hearing, to submit questions in writing, and to have the questions and answers included as part of the record.

Chairman FAUNTROY. Without objection, so ordered.

Mr. RIDGE. Mr. Axilrod, in your testimony you indicated the exchange value of the dollar had dropped about 8 percent on a graduated basis since the G–5 meeting and is now about 22 percent below its February peak. In the hiatus between the February peak and the G–5 intervention, there seems to have been a weakening of that dollar.

One wonders, then, if the reduction in the exchange value has more to do with the psychological impact of the intervention or the actual intervention, itself. Would you care to comment on that?

Mr. AXILROD. Well, I think before the intervention program, the drop that had occurred after the February peak had—of course, this is a matter of some judgment—but had tended to stabilize—the dollar had tended to stabilize at lower levels. I have no doubt that the intervention announcement, itself, had some effect, because much of the drop since the G–5 announcement occurred very promptly, not all, but very much of it occurred very promptly after the announcement. So that was clearly a psychological effect, just from the announcement.

So I think that a good part of it did affect the market psychologically. And, of course, there has been a sizable amount of intervention to keep the dollar from rising from there. What intervention has not done, which I think is very good, it hasn't affected market psychology excessively. Confidence does remain pretty high in the dollar, as it should. So I would say the effect of intervention on the dollar has been partly psychological and partly direct operations.

Mr. RIDGE. I guess the flip side of that question would be given the peak in February, the time lag between the February peak and the G–5 intervention and the weakening of the dollar, it may be very difficult to quantify the effect of intervention. Was the weakening a trend from your view? Was it essential at that time given the apparent trend to intervene at that particular point?

Mr. AXILROD. Well, for some time I suspect all economists, virtually all economists, I wouldn't say all, have been expecting the dollar to weaken, and the surprise has been that it hasn't year after year during the early 1980s. So I would not say it is too surprising that it began coming down from that February peak in a moderate way.

Mr. RIDGE. I know one of the concerns of our chairman, many of my colleagues and quite a few analysts, is that in the years ahead interest rates may become progressively more influenced by foreign exchange considerations. Do you agree with this analysis? Are you concerned about the impact of those exchange considerations?

Mr. AXILROD. Well, in a way, I think I agree with it. I would put it in a somewhat broader context though. I think our economy has over the years become more open, more internationalized, more

and more industries competing with foreign suppliers, and more and more industries dependent in part on exports.

Thus, the exchange rate in some sense has a direct effect on industries ability to compete in the same sense as an interest rate is a cost to a homebuyer or a cost to a large business who has a purely domestic business. So as the dollar goes down on exchange markets, it has some sort of expansive effects on real activity, but it carries with it also the other edge of that sword, which is it has a direct effect on import prices and thus on domestic prices.

A drop in the dollar becomes a plus for economic activity, but it becomes a negative in terms of worrying about inflation. You are necessarily forced into a balancing of those two forces. If the market comes to the view the inflationary forces are going to predominate, there will be upward pressure on interest rates just from market forces alone. If the market comes to the view there will be an expansive effect on economic activity and if that comes on top of an economy that is already using its resources close to the utmost, then there will probably again be some lift to market interest rates, a rising effect, just from the market itself anticipating pressures on real and credit resources.

And that is why I mentioned earlier it is very difficult to judge this until you see the exact circumstances in which these variations in the dollar are occurring.

Mr. RIDGE. I appreciate that. Thank you, Mr. Axilrod.

Chairman FAUNTROY. The time of the gentleman has expired. Mr. McCollum.

Mr. MCCOLLUM. Thank you. Mr. Axilrod, I am very pleased your statement included a comment about we need very much to reduce the Federal deficit and that would alleviate a lot of these pressures. I think a lot of us are aware of that, and I hope within the next few days we are able to accomplish that.

One of the questions I had, and I unfortunately had to leave the room, so I am not sure whether you have addressed it, is what symptoms or signs would we be looking to to determine whether or not the intervention in the next few weeks or next few months is continuing to succeed? Is it strictly a question of watching the dollar value and seeing if it drops, or is there something more that fundamentally we have to look at, such as the question of whether or not the yen or the purchases, I should say, by the Bank of Japan, the intervention there, is excessive for the net result that we are actually getting? What are we looking at?

Mr. AXILROD. Well, we have had, since the announcement, what I would describe as quite an orderly appreciation of foreign currencies, a drop in the dollar on the order of 8 percent on a trade-weighted basis, or if you look at it just against the G–5 currencies, actually a little more. And I would say, looking at events to date, the operation has been a success. It has been a reasonable drop, moderate and orderly. It hasn't been cumulative and markets haven't been volatile connoting signs of doubt, no one knowing what to do.

I think it is very hard to predict the future in this area, and I would certainly hesitate to do so. But one sign of success is really a market that remains orderly, a market that moves in a way which doesn't fluctuate excessively one way or the other, so you are really

getting a good sense of people coming to decisions based on their long-run perspective and rather than on short-term fear and uncertainty.

Mr. MCCOLLUM. Do we have to hold that 8-percent drop for the next year or something close to that in order to claim success, or can we already say that the intervention has been successful, just because it has happened up to this point?

Mr. AXILROD. I think you can certainly say it has been successful so far, and I think as to what the future brings, Mr. Congressman, I don't think that I am really quite in a position, or anyone else——

Mr. MCCOLLUM. I understand that. I am asking you, does it become an unsuccessful policy if the value of the dollar does not stay at the approximate level where it is now and rises back significantly in the next 8 or 10 months?

Mr. AXILROD. If I could put it in a broader context, if our economy turned out—without predicting anything—to be quite strong, if there was a renewed upsurge of investment, I think you would probably see in that circumstance a great desire, a continuing large desire to put money here. Under those circumstances the dollar would probably tend to edge up. I don't think that would be considered success or not success. That would be a reflection of the actual circumstance that we would have at that point. Intervention today occurs in entirely different circumstances.

Mr. MCCOLLUM. Is this reduction that we have just seen, assuming we don't see anything further of great significance on the downward side the next few months, is it going to result in the next year or two in a significant change in our trade imbalance?

Mr. AXILROD. I think it, at the margin, will change our trade imbalance.

Mr. MCCOLLUM. You mean not a whole lot, is that what you mean, at the margin?

Mr. AXILROD. I think it would do it to some degree, that is right. I would not really want to quantify it, but I think most econometricians, if I may use that word, would run through their models and say this level of dollar is going to give you trade balance or balance in your current account. The issue isn't that particularly, but rather whether the market is or is not going to come to think that we need a lower rate level, and under what circumstances. To some extent——

Mr. MCCOLLUM. The psychology is involved in all this, I understand. You are saying the psychology, in part, is in putting the money here. The psychology, in part, is whether we are pursuing a policy to bring the value of the dollar down, which may, in turn, stimulate some of the exports to this country or more imports to the United States. Is that not part of all of this?

Mr. AXILROD. As people perceive that the United States has a stable economy, where the real rate of return is high, money will want to flow in here. As money wants to flow in here on a net basis, we have to have the current account deficit that in effect, permits the net inflow of capital.

Mr. MCCOLLUM. One last question. Do you maintain major interventionist policies over the next few months to drive the dollar

down further, or is the primary purpose just stabilization at this point, being happy with where it has gone so far?

Mr. AXILROD. Mr. Congressman, if I may kind of edge around that question, I think it really depends on the circumstances that will come to exist at that time. And I don't think that one can tell exactly what is going to happen to interest rates and the economy over the next few months. The answers to all of those questions are embedded in your——

Mr. MCCOLLUM. If nothing changes, if everything stays the way it is today, we don't have any significant changes in those factors you have described, do we need more intervention in your opinion? Do we need to bring the dollar down more?

Mr. AXILROD. I think over the long run, it is very likely that we cannot count on $130 billion current account deficit. We may be able to count on some deficit, we might have to go into balance or surplus, but I don't think we can count on that $130 billion current account deficit.

There are only a few ways to reduce the deficit. One is to have more growth abroad, which will expand the demand for our exports, given the exchange rate, and I think that would be a helpful development.

Another would be over time to make our industries more competitive. That will occur in two ways. One is more productive, efficient investment. We are getting that here. And the second would be a change in the exchange rate. The whole issue is how fast, how to balance those things, and how fast it should occur. In that sense, you could conceive of over time a further gradual reduction in the exchange rate. You can't be sure how fast or when, and it would depend on the degree to which we are getting expansion abroad and improvements in productivity here.

Mr. MCCOLLUM. I know my time is up and I see what you are saying, and I can see you are skirting my question each time I ask it. Thank you, Congressman.

Chairman FAUNTROY. Thank you. I yield to Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

Mr. Axilrod, thank you for your testimony.

Two questions. The first one is can you tell me what the last date that the United States, last year in which we ran a current account surplus? Was that 1981?

Mr. AXILROD. Yes, there were surpluses in 1980 and 1981.

Mr. CARPER. The other question is absent meaningful action by the Congress, by the executive and legislative branches on meaningful deficit reduction, either this year or the beginning of next year, how long can intervention in currency markets—how long can that hold out promises of either bringing down the value of the dollar further or simply holding it at its current levels?

Mr. AXILROD. It is conventional wisdom among analysts of this thing that intervention in currency markets, or other markets, can't really push things against the fundamentals very long. And it is most successful in a sense when it convinces the market—and in part the answer to Mr. Ridge's question—when it convinces the market fundamentals are going the same way.

In the G–5 announcement, it was indicated that intervention would be in the context of convergence of the economies, of mone-

tary and fiscal policy approaches, and of deregulatory free market policies. In that context, the intervention took place. If that context turns out to be wrong, if it turns out there is more inflation or it turns out progress isn't made on the fiscal front which is expected, I don't think you have a context in which the intervention can be successful.

Mr. CARPER. Has the intervention entered into a second phase? If so, how does this phase differ from the initial phase?

Mr. AXILROD. I have been struggling not to answer that question, which I think Mr. McCollum also raised, and I don't believe I have anything more enlightening to say than I did in answer to Mr. McCollum's questions—which was this has to be appraised in light of the circumstances that are going to be facing us over the next few months.

Mr. CARPER. Could you take a moment and share with me a simple nuts and bolts explanation how in a practical way the intervention has taken place since I think September 22?

Mr. AXILROD. There has been intervention by the United States, and other countries. This intervention simply means the acquisition of foreign currencies through sales of dollars. When the Federal Reserve buys them our payment adds to the reserve account of some bank. The entity from whom the security is bought indicates the bank holding its account, and payment for the currency adds to the reserves of that bank. The seller of the foreign currency may then use the dollar funds—for instance, invest them—in which case they could be transferred out of the original bank, but would remain in the banking system somewhere. Our purchase of foreign currencies thus creates bank reserves.

If that amount of reserves is inconsistent with what the FOMC has decided is appropriate in their decision, then at some point very shortly that foreign currency operation will be accompanied either by a sale of U.S. Government securities or by less of a purchase than would otherwise be made. So we would find that the Federal Reserve would have a few more foreign currency assets and a few less U.S. Government security assets. But the amount of reserves would be roughly what we would otherwise have wanted, taking account of the economy, business, and the exchange markets to the extent each enter into the thinking of the FOMC about reserve conditions. That is how it affects us technically.

Mr. CARPER. And has that approach and intervention since September 22 continued or are we continuing to——

Mr. AXILROD. This is essentially what would have been going on at other times when we would have been intervening. This is the biggest intervention in quite some time, and so the magnitudes are larger.

Another aspect of this, I should mention, of course, is that when a foreign country is selling dollars, these dollars would probably have been held in Treasury securities. Those securities would be sold, and would have to be absorbed, in our market. That could have transitory effects on our interest rates. But the size of our market is so large that this kind of unwinding of the exchange operation does not I think have a meaningful interest rate effect.

Mr. CARPER. Thank you very much.

Chairman FAUNTROY. Thank you. The time of the gentleman has expired.

We have been joined by Congressman Doug Barnard. Do you have questions at this time.

Mr. BARNARD. No.

Chairman FAUNTROY. The inflow of foreign capital has aided domestic economic growth through lower interest rates. And, while these inflows have balanced the current account deficit, they have nonetheless freed funds for private investment which would otherwise not have been available. Has the Fed, or anyone else to your knowledge, calculated the effect this has had on economic growth and interest rates?

Mr. AXILROD. I think that I have not much doubt that investment spending for plant and equipment, which has tapered off recently, has been helped by this net inflow of funds.

I would also think that spending on housing over the past several years, the extent of investment in housing, has been helped by this inflow of funds, because if you balance our savings and investment account, if you look at the amount of net domestic saving generated by people in the United States out of their personal income and by corporations out of their retained earnings, if you look at that and compare it with the demand on that savings which comes from the budget deficit and private investment spending for housing and those things I have mentioned, there is a big gap—on the order of 25 percent or more recently.

And this net inflow of funds from abroad has filled that gap. If we didn't have that we would either have had to have a lot more savings domestically through some mechanism or other, or we would have had a lot less investment, given the deficit, and the equilibrating mechanism in that case is normally interest rates.

Chairman FAUNTROY. I assume that you invest the foreign currency holdings in foreign currency dominated securities. What losses have you suffered in these securities? What securities are you presently holding in the system?

Mr. AXILROD. We hold $1 to $1½ billion actually in securities and the balance in the form of deposits at term, which earn a market rate of interest. A capacity to invest in securities, which Congress gave us some years ago, has helped us greatly in managing this and earning a market rate of return on the deposits, because we have these alternatives. The exchange values——

Chairman FAUNTROY. Looking at losses now.

Mr. AXILROD. We had considerable losses on foreign currency holdings—mainly "unrealized" losses on holdings—in the period of a rising dollar. They have varied from $450 million to over $1 billion per year in the 1982-84 period. That is changing now. We may still be in a loss situation compared with our historical cost of acquiring foreign exchange, but we are moving toward a profit.

Chairman FAUNTROY. How do you account for gains and losses?

Mr. AXILROD. We actually take the unrealized loss into account when we pay our $15 billion or so over to the Treasury each year. The unrealized gains and losses are counted in income, so if we have an unrealized loss, income is in effect reduced and we pay a little less to the Treasury. And when we have a gain we pay a little more to the Treasury. That is why I had mentioned in my testimo-

ny that you just can't look at the interest differential. You have to also evaluate whether the dollar has gone up and down in seeing the impact on earnings.

Chairman FAUNTROY. Are we approaching a level of holdings that might require the use of these securities as collateral for Federal Reserve notes?

Mr. AXILROD. No; I think without even considering these foreign holdings, we have in the area of $20 billion of surplus collateral. So we are well away from that.

Chairman FAUNTROY. Mr. McCollum.

Mr. MCCOLLUM. I only have one followup question. This is as a general question, Mr. Axilrod.

Some of the witnesses today, some of the people who are critics in the world, they say the emphasis and concern on deficits and their relationship to higher interest rates and higher interest rates relationship to the strong dollar are misplaced, that in fact statistically it is the reverse, that in fact we have situation if you measure it schematically that shows that you actually have a higher dollar with falling interest rates and you have falling interest rates with higher deficits. How do you rebut that? I assume you do in some way.

Mr. AXILROD. I confess I don't often get into those debates. I am well aware of the ones you are referring to. Since late 1979–80, we have had a substantial fall in the rate of inflation. It fell mostly early in the period; it has been stable at 3 or 4 percent for the past few years. I think you would expect the nominal level of interest rates to drop under those circumstances, and it in fact did.

You would have expected under those circumstances some rise in the dollar, since the dollar had dropped in 1978 and 1979 because of fears of inflation in the United States, which made holding dollars a bad bet, and the dollar dropped sharply.

As fears of inflation abated you then had a drop in nominal interest rates and a rise in the nominal and real exchange value of the dollar, both reflecting the same event. I think that would have been expected by most people who looked at it. The surprise was the extent to which the dollar rose. I think you can explain the extent of rise in part by a number of other occurrences, some unexpected by the market and some perhaps expected depending on the depth and care of analysis.

We have debt problems abroad. This has caused foreign countries, the underdeveloped countries, to be less of a good outlet for funds; so outflows of bank funds from the United States have been reduced. That means your net flow from abroad is increased because less is going out, even while the same amount is coming in.

Of course, we have also had sluggish growth in most major industrial countries, and other uncertainties at times. Thus, many people felt that the best place to put their money was the United States, because we had a strong economic rebound and our inflation rate was being reduced. I think the explanation for the behavior of exchange rates and interest rates can be found in these very practical terms.

What I look at, Congressman McCollum, in evaluating the relation of interest rates to the deficit is the balance of saving in investment. Looking at our income accounts, I can't see enough do-

mestic savings to meet the budget deficit plus domestic investment. I mean that has not occurred, and the balance has been achieved through net foreign investment of $130 billion or thereabouts. Recently, that has been the thing that has balanced the budget deficit and investment against our limited domestic saving. So you have to ask yourself if you didn't have that inflow from abroad, how are you going to achieve balance?

Obviously either saving has to go up or investment has to go down. How do these things happen? That gets to the worry about what would happen to interest rates and domestic income generation in the process.

Mr. MCCOLLUM. What you are saying, even those statistics can come along and show this correlation that seems to be contrary to these is we ought to get deficits down. There are other plausible explanations that account for that difference and then some.

Mr. AXILROD. Yes; and an economist would say you have to make your comparison with what otherwise would have occurred. It isn't so much correlating two actual developments, but comparing actual with what would otherwise have occurred. That is where the debate really lies.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Chairman FAUNTROY. We thank you.

Mr. Ridge.

Mr. RIDGE. I have no questions.

Chairman FAUNTROY. Thank you, Mr. Axilrod. We appreciate so much your testimony.

I welcome to the witness table Dr. Ralph Bryant of the Brookings Institution; Dr. Jeff Frankel, associate professor of the University of California at Berkeley; Dr. Mieczyslaw Karczmar of the European American Bank; Kenneth Rempell from Merrill Lynch; and Dr. T.E. Kilcollin, senior vice president and chief economist of the Chicago Mercantile Exchange.

Gentlemen, we have your statements. I am going to ask you to present your statements—we will do that serially—and then we will have questioning.

Dr. Bryant, please proceed.

STATEMENT OF RALPH C. BRYANT, BROOKINGS INSTITUTION

Mr. BRYANT. Thank you, Mr. Chairman.

I appreciate the opportunity to share my views with this subcommittee on macroeconomic policies, in particular the international dimensions of the current situation. I believe the current macroeconomic outlook is unsatisfactory and risky both for the U.S. economy and the world economy. In particular, in my view, the dollar is still substantially out of line with the value that would produce a sustainable pattern of U.S. international transactions over the medium and long run.

Some of the main facts that lead me to this conclusion are pictured in the first three pages of my handout. If I may, I will call your attention to the first plot which plots the current trade deficit and other transactions. As I think you can see from that chart, we are going off the map in terms of historical experience.

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If you turn to the second chart, which is a counterpart to the first, you can see the net capital flows that are the balancing item or the financing for the big current account deficit. Some of that is errors and omissions, which we believe is in great part an unrecorded capital flow.

Perhaps most startling of all, the third chart plots the net external assets of the U.S. economy vis-a-vis the rest of the world, and that too, I think, clearly shows we are way off the map in terms of what we have experienced in the past.

Chairman FAUNTROY. I want to tell you, this graph you have given us is shocking.

Mr. BRYANT. I think it is, Mr. Chairman. The change in the current account balance and the net external asset position of the United States, which you see in that chart, in my view can be very largely explained by the big appreciation of the dollar since 1980.

If you will turn to the following chart, there is a picture of two measures of the value of the dollar. These are both weighted average measures.

Now, some factors other than the appreciation of the dollar have contributed to the current account deficit, without doubt. The relative cyclical position of the U.S. economy vis-a-vis the rest of the world has meant that our faster growth worsened the current account deficit in this period. It is also true that American exports are concentrated in developing countries that have been especially hard hit by the Third World debt situation. So there are some other significant factors that have worked in the direction of worsening the current account. On the other hand, our petroleum imports to the United States are $30 billion less than they were in the peak year of the early 1980's. That factor works in the opposite direction.

When we try to add this up, most analysts come out with the conclusion that two-thirds, and quite possibly 75 percent or more, of the deterioration in the current account can be ascribed to exchange rate developments. I know one estimate that makes that proportion as high as 85 or 90 percent.

What might happen if the dollar stayed as strong as it is now with a continuing large current account deficit and an ever-increasing external debt? Would foreign governments and private foreigners indefinitely add dollar securities to their wealth portfolios, having a significantly rising fraction of their wealth in claims in the United States? Could we continue to keep protectionist pressures at bay in the United States?

None of us who have tried to analyze these trends can see a way to pinpoint exactly when or how they would become reversed. But it certainly stretches credibility beyond the breaking point to think they could continue indefinitely.

If eventually the current account deficit does have to fall back to a much more modest size and if the accumulation of external debt slows down or ceases, I think a necessary condition for that outcome is a substantial depreciation of the dollar. It is true, we have had a large depreciation since the peak in February and March. Those figures have been referred to already. My table 5 summarizes both what the tremendous runup was from the summer of

1980 to the peak in February and March 1985 and also the decline since then to the end of October.

But despite that decline, we need—it seems to me—to ask the question: How much further might the dollar have to depreciate before it would reach a range where in time the current account deficit and the accumulation of external debt would decline to sustainable, acceptable rates?

I cannot answer that question precisely, nor do I think anyone else in the economics profession can. In my written testimony, I am going to include some caveats about how difficult these numbers are to compute and point out that they are specific to the kinds of models people use and the assumptions that are made.

But glossing over the important qualifications, let me just say that under virtually all calculations with which I am familiar or which I can imagine, the dollar will have to depreciate substantially further to bring the current account and external debt back to a reasonable range.

The amount of the improvement we might need to be thinking about in the current account could be as large as $100 billion. In order to get such an improvement, I believe we would have to see at least another 20 or 25 percent depreciation of the dollar—I am speaking here in terms of the Federal Reserve multilateral weighted index—and the number could easily be much greater than that, perhaps 30 or 35 percent. Larger numbers like that would take the dollar back to where we were in the summer of 1980, or conceivably even below that point.

I want to stress that these numbers I am referring to are not exchange rate predictions. Many things will influence what the exchange rate will actually do. Rather, what I am referring to here is the amount of depreciation that would probably be required to bring the current account deficit and the external debt back to a reasonable range.

I think it is right to focus on the weighted average value of the dollar when we discuss these questions, as I have. But I have included a chart that shows you not only those weighted average measures but also the bilateral exchange rates, the dollar-Deutsche mark exchange rate and the yen-dollar exchange rate (see chart 6 in my handout). As you see, the bilateral exchange rates against individual currencies behave differently, and those are the ones you read about in the newspapers every day. One has to be careful when making calculations of the sort to which I was referring, to use a weighted average measure.

I also could not resist putting in the next chart, chart 7 in my handout, which does the same thing for the Japanese yen; it shows two weighted average measures of the yen and also the U.S. dollar-yen exchange rate. I do not think it is widely appreciated that the Japanese yen has substantially appreciated over the last 2 years, even though much of the time it was weak against the U.S. dollar, especially after the large move in the last 6 weeks and the further large move yesterday. The yen is now much stronger in the exchange markets than it has been over the whole last 15 years.

That leads me to believe that it is quite wrong to see Japan and the imbalance in the yen and the Japanese balance of payments as the major cause of American international economic difficulties. It

is rather easy to make the Japanese a scapegoat, but it seems to me we have much more of a dollar problem than we have a yen problem.

What I would like to do now is turn briefly to a sketch of some alternative scenarios. What might the world look like in the next few years? For the purpose of the discussion here, I have classified the possibilities into four groups. I have listed them on page 8 of my handout. I have labeled them a little provocatively. I want to talk mainly about the second and third of these possibilities, but before I do that, let me say a brief word about the first.

It seems to me that decisive action to reduce the U.S. budget deficit, which in turn would enable the Fed to have a less contractionary monetary policy than it has been following, is the preferable scenario we should be trying to follow on economic grounds. Rates of interest could be lower than they otherwise would be; capital formation and growth in productivity would be more assured in the U.S. economy than they have been. This would definitely lead, in my view, to a substantial further depreciation of the dollar—because of desirable policy changes. These would be favorable developments, and this would much reduce what I worry about in the second scenario, which is a precipitous fall in the dollar's value in the exchange markets.

If the United States could take such policy actions, that would create opportunities for foreign governments to take policy actions in response. Monetary policy in other countries could be a little easier and, still better, countries like Germany and Japan could ease their fiscal situations a little bit. This outcome would be preferable for the United States and for the rest of the world.

Unfortunately, I do not think the chances of our experiencing this in the next 2 years are very high—and I certainly think, Gramm-Rudman notwithstanding. I want to say something about that at the end.

What about the possibility of the chickens coming home to roost with a vengeance? What I mean by that is the possibility that we could have a financial market crisis in which investors would try to move out of assets denominated in dollars into assets denominated in foreign currencies. I think even those market participants who don't want to move into foreign-currency assets would like to get out of longer run assets into more liquid assets.

This could be triggered by a variety of events. We can not foresee which one might do it. It might be some action by Congress, a failure of firms; it might be some event that happens abroad. It would be associated with the perception that the situation is out of control and that the current stalemate couldn't be resolved without a market crisis.

I think it is likely, if this scenario were to materialize, that the fall of the dollar could be quite large and the manner could be very disorderly. One would expect bond markets and stock markets to be very turbulent, too.

If this were to happen, the choices facing the Federal Reserve would be very difficult. The choices for domestic monetary policy would fall on a spectrum where the two ends are accommodating the pressures by leaning very strongly against the wind—that is, open market purchases of securities that prevented interest rates

from rising nearly as much as they otherwise would have—or at the other end, what you could characterize as hang tough—in which interest rates rise, and the dollar falls sharply without much offsetting action by the Federal Reserve.

I am not now going to go through some of the consequences of each of those options, although I will put some of that in my written version, Mr. Chairman. I will also say a little bit about what the Fed might do under those circumstances.

This possibility of a financial crisis is not the most likely outcome for the next 2 years. It might have 2 or 3 chances out of 10 of occurring. But even that high a probability seems to me is a cause for worry. And it makes me think we ought to be taking out insurance.

The best insurance possible would be moving decisively to bring our budgetary imbalance under control. Such action would unambiguously reduce the likelihood of economic chickens coming home to roost with a vengeance. The story that comes to mind is the one about the sailing ship captain who asks "What do you do if you find yourself windward of an island in a typhoon?" His answer was "You do not find yourself windward of an island in a typhoon."

The most likely outcome, I am afraid, is muddling along without a financial crisis. Financial markets probably would give us more of the same. They would be relatively phlegmatic despite little progress on the U.S. policy mix. Output and employment might be pretty lackluster, but would hold up well enough so we would not have a recession in the next 2 years. Interest rates might not rise very much, and if they do, they might rise in a relatively orderly way. You would get some further declines in the dollar probably, but in a way that would not be so terribly disorderly. It probably would occur in discreet, large steps rather than some gentle, gradual decline.

Well, this muddling-along outlook seems to me the more likely outcome. The chances of experiencing this outcome are higher, the smaller is the misalignment in the dollar's exchange value I was referring to. If you take the lower end of the estimates as the likely ones, that increases the likelihood of the muddle-along outlook. If we can begin to see evidence that the depreciation of the dollar we have already had is beginning to improve the current account, that also I think reduces the chances somewhat of the financial crisis outcome.

Choices facing the Fed under muddle-along conditions will not be comfortable. The Fed would be subject to the cross currents it has experienced in the last several years. But at least the choices will not be as impossible as they would be if we got into a financial crisis.

For a complete list of outcomes, we ought to recognize the small probability that the next 2 years could come with a well-above average dose of good luck. That is what I mean by no sign of the chickens coming home yet. That might include things like buoyant but not excessively rapid growth in the economy. Despite the buoyant growth, there might be little or no upward market pressure on interest rates, and continued bullish attitudes about the U.S. economy and exchange value of the dollar. So maybe the dollar might

even strengthen from its current level, or at least not weaken further. But the current account deficit would continue very large.

There are some economists who believe this sanguine outlook is the likely one for the next few years. I, personally, think the chances of this are relatively small. If it did occur, I think only part of it would be genuine good luck. The buoyant real growth would be something we could all wish for, but a continued very strong dollar with all its distortions for the composition of output in the American economy and the rapid accumulation of external debt would not, it seems to me, constitute good luck. We really need a further depreciation of the dollar to get the economy back on a sound track.

I have another table in the handout which I think I will skip over since I do not want to take too much time away from other panelists.

I am going to make a few comments now about exchange market intervention. I am not under the same constraints as my former colleague, Steve Axilrod, so I can perhaps be a little bolder or less cautious than he was in talking about this subject.

What role could exchange market intervention play in the various scenarios I have identified? In my view, it has a potentially helpful role in offsetting frenetic market activity. I think it also can play a helpful role by giving signals in the financial markets about policymakers' diagnoses of what the fundamentals are. Occasionally even, in principle, it could be used by policymakers to signal intentions about their own policy actions.

Now, what did happen in September or over the course of the summer, and what we learned about on September 22, is that the U.S. Treasury seemed fundamentally to change its attitude about exchange market intervention. Whereas it had a quite dogmatic view before, their current position seems to be much more pragmatic. That seems, to me, a very welcome, overdue shift, and I think it merits the support of the Congress.

I also think it was a constructive aspect of the group of five meeting in September in New York that they announced that they were ready to cooperate more closely to encourage some further orderly appreciation of the main nondollar currencies against the dollar, when to do so would be helpful. From the information we currently get, it does look as though actual intervention has been considerably more active since September 22 than it was before.

While intervention can play a useful role, it seems to me it cannot do more than that. Extensive analysis of intervention operations where the analysis has been carried out both by central banks themselves and by academic economists, suggests intervention which leaves domestic bank reserves unchanged—that is, so-called sterilized intervention—is not a powerful, reliable instrument with which to influence exchange rates. This was referred to earlier. And I agree with what was said about that and, therefore, I will not take very much time here.

What concerns me is that exchange market intervention might be taken as a substitute for more fundamental changes in domestic macroeconomic policies. If that were to happen, I think that would be a dangerous illusion. In particular, if anyone in the administration or the Congress were to think of aggressive exchange market

intervention as a way of deferring actions to reduce the budget deficit, it would be appropriate to label that view as seriously misguided.

When the group of five ministers met on September 22, they asserted that the fundamental economic conditions, including their own policies, were already improved and would prospectively improve further. A few points can be marshaled in favor of their strong assertion. The President and Congress did make some progress this summer on the U.S. budget, although not nearly enough. One or two of the European economies seem to have improved prospects for growth. By and large, however, the assertion of the group of five ministers was more hope than fact. The fundamentals do not seem as auspicious as the language of their communique suggests, and this makes me dubious that one should place a lot of confidence in the G–5 ministers' commitment to intervention, especially if that is the only major thing that is going to change.

I would like to conclude with an observation about the current political impasse in the country about macroeconomic policies. The economic facts we are discussing this morning lead one to the conclusion that the country badly needs its political leaders to forge a compromise solution to move the budget decisively back towards balance.

But the commonsense view that a political compromise needs to be forged doesn't seem to be so common in Washington. Apparently the President and Congress are concerned with jockeying for short-range strategic advantage, and the name of the game is to avoid blame rather than exert leadership to arrange the compromise.

The most recent chapter in this story is the current snafu about the debt limit and Gramm-Rudman legislation. Even the House Democratic version of this idea, which seems to me much less bad than the Senate version, is part confidence trick. To be blunt, what the proposed legislation says is that this President and Congress mandate that the President and Congress in the future will somehow, if necessary mechanically and ineptly, do what the current President and Congress don't have the courage and wit to do now.

The most thoughtful analyses of the Gramm-Rudman type of legislation predict that the legislation, if passed, would add to the uncertainty about budget prospects, not reduce it.

As the general public observes this impasse, what we perceive is virtually the entire political leadership of the country bent over with their ears to the ground waiting to hear what a political consensus might be rather than helping to develop the needed consensus. To us followers, this presents a distinctly uninspiring view.

I am especially critical of the President and the administration for their failure of leaderhip. But the Democratic Party, it seems to me, also deserves a lot of criticism. Many Democrats in the Congress let the 1981 Kemp-Roth tax reduction legislation go through, which seems to me a major cause of our current troubles. Especially until last Friday it looked as though something similar might be happening about Gramm-Rudman.

I am sure as an economist I don't sufficiently appreciate all the difficulties and nuances in the political situation. But even so, I scratch my head and say "Can it really be that the political constraints are so binding as to make it impossible to develop a genu-

ine political compromise?" To me, the art of politics is not the art of avoiding tradeoffs. I believe we can reasonably expect more candor and courage from our political leaders—indeed more leadership—than we recently have been getting.

[The prepared statement of Mr. Bryant and the charts referred to in his oral testimony follow:]

Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

Testimony by Ralph C. Bryant
Senior Fellow, Brookings Institution*

November 7, 1985

I appreciate the opportunity to share my views with this Subcommittee on the international dimensions of current macroeconomic developments and policies. My comments will analyze the external position of the U.S. economy and the exchange value of the dollar, sketch some alternative possibilities for the short-run outlook, and make several observations about exchange-market intervention and the roles it can or cannot play in promoting the goals of economic policy. I will conclude by expressing concern about the political constraints preventing the United States from taking the policy actions about our budget deficit and fiscal-monetary mix that are so long overdue.

The Unsustainable External Economic Situation

The current macroeconomic situation is unsatisfactory and risky -- both for the U.S. economy and the world economy. In particular, the dollar is still substantially out of line with a value consistent with a sustainable pattern of U.S. international transactions over the medium and long run.

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*The views expressed are those of Mr. Bryant and should not be attributed to the officers, trustees, or other staff members of the Brookings Institution.

Some of the main facts that lead me to this conclusion are pictured in the accompanying charts. Figure 1 shows the current-account balance and its division into trade and other transactions since 1960. In the first half of 1985 (third quarter figures are not yet available), the current-account deficit was $124 billion at an annual rate. Other current-account transactions, which until 1982 had been registering a progressively increasing surplus, had fallen close to zero by the first half of 1985.

The second chart shows the very large net capital inflows in 1984 and 1985 associated with the large current-account deficits. The net errors and omissions item in the balance-of-payments accounts, which until the mid-1970s was much more modest in size, has recently been strongly positive; an uncertain but probably large fraction of this item represents unrecorded net capital inflows.

Figure 3 shows the net external-asset position of the U.S. economy (the stock counterpart to the flows in the capital account of the balance of payments). This chart makes it still clearer that recent developments are "off the map" relative to historical experience and headed at great speed into uncharted territory. For each year that the United States continues to run mammoth current-account deficits, there will be still another huge decline in the net external-asset position.[1]

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1. Much the most important determinant of changes in the net external-asset position from one year end to the next during the rest of the 1980s will be the size of the current-account deficit during the year. Changes in the net external-asset position also occur because of valuation adjustments to assets and liabilities. I have included in Figure 3 a rough, and possibly too optimistic, estimate of the position for end 1985; my projected decline for 1985 is some $15 billion less than the annual rate of the current-account deficit in the first half of 1985.

Figure 1

CURRENT-ACCOUNT TRANSACTIONS IN THE U.S. BALANCE OF PAYMENTS

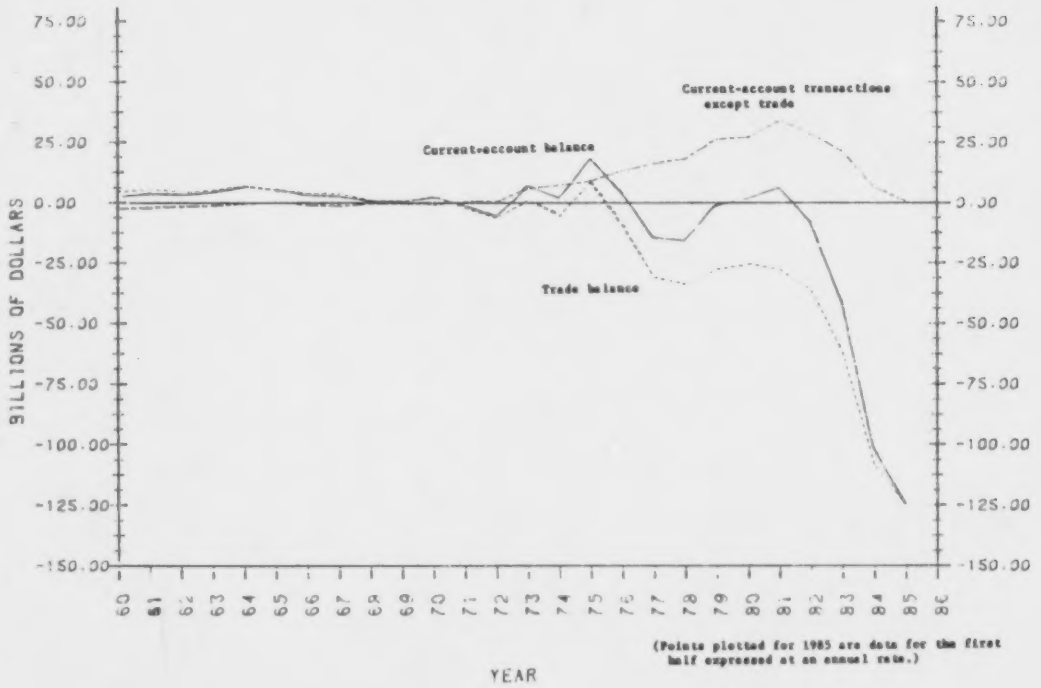


Figure 2

CURRENT-ACCOUNT BALANCE AND NET CAPITAL FLOWS

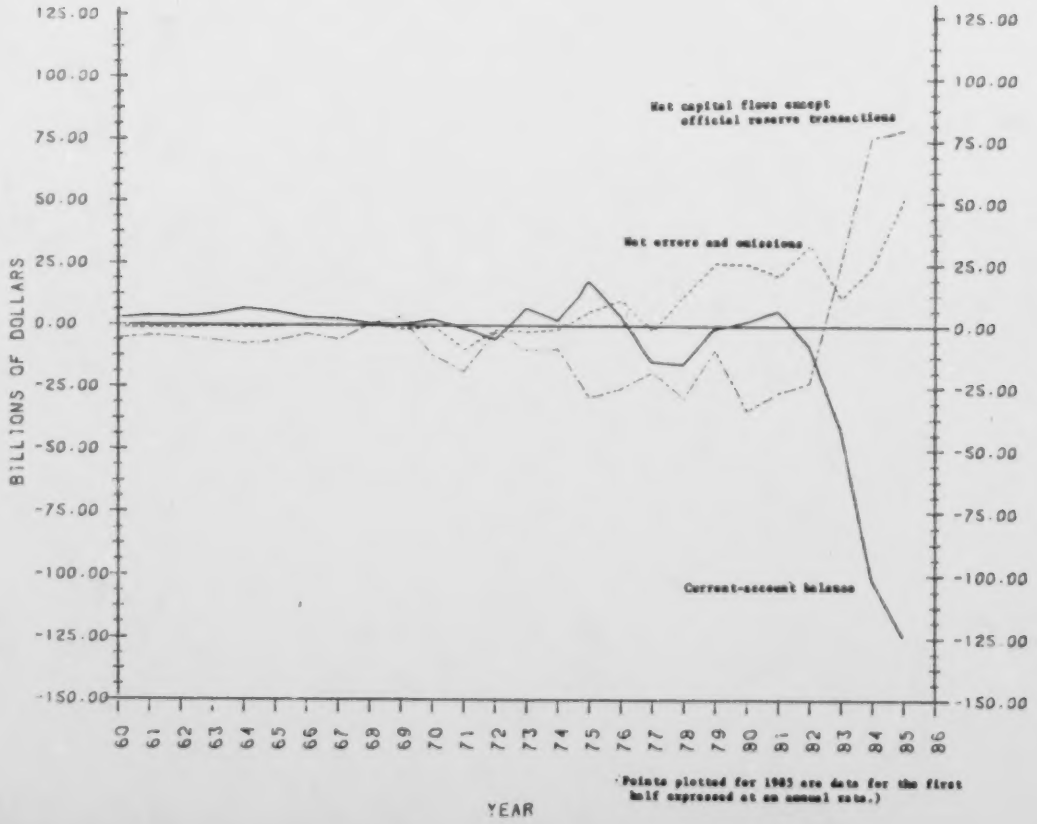
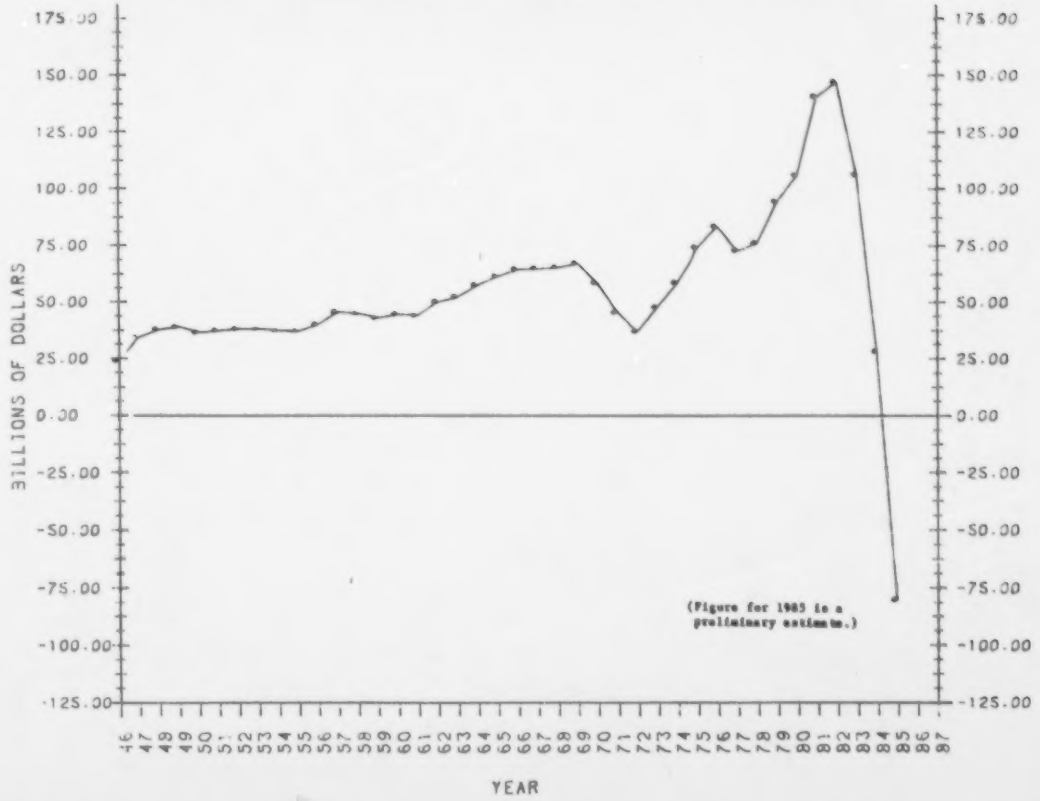


Figure 3

NET EXTERNAL ASSET POSITION OF THE UNITED STATES

(Assets abroad owned by U.S. residents less assets in the United States owned by foreign residents, outstanding net position at end of year.)



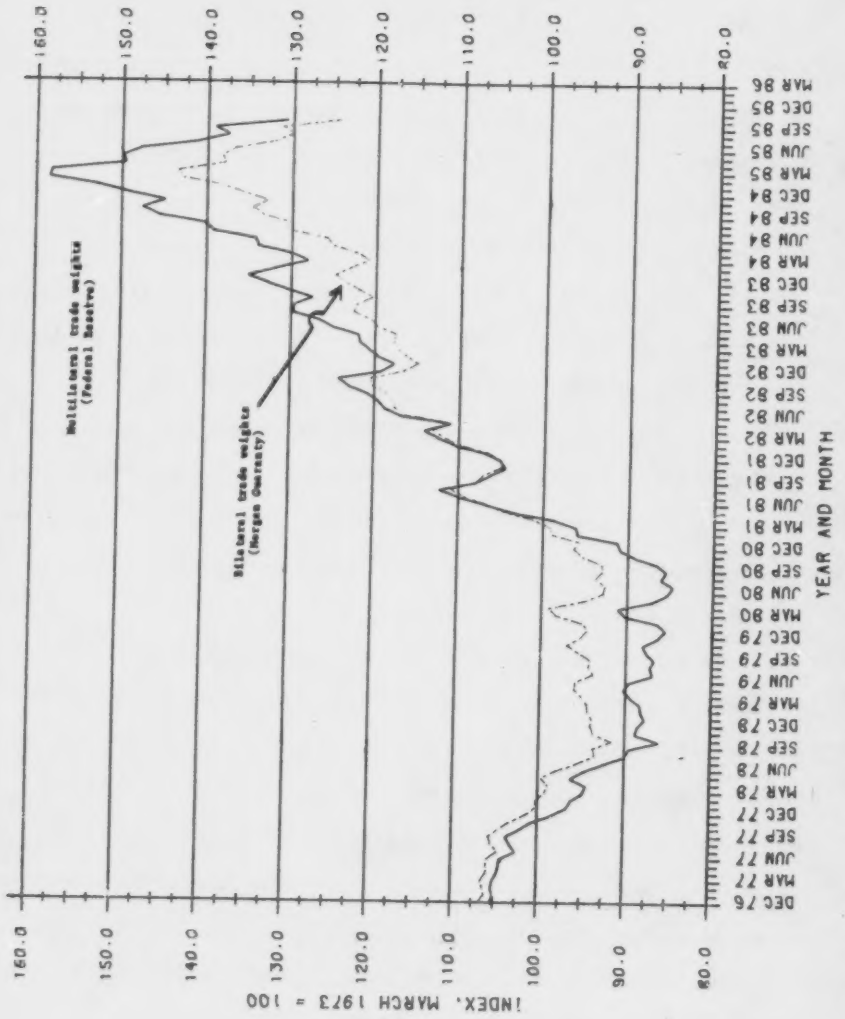
The rapid deterioration of the current-account balance in the last five years can be predominantly explained by the very large appreciation of the dollar since 1980. Estimates of the fraction of the current-account deterioration attributable to the dollar's appreciation range upwards from two thirds, with some estimates as high as 85-90 percent.

Two measures of the exchange value of the dollar, both weighted averages of exchange rates against the individual currencies of other major countries, are charted in Figure 4. According to the Federal Reserve measure, which weights the currencies of the Group-of-Ten countries in proportion to their importance in total world trade (so-called "multilateral" trade weights), the dollar appreciated by the extraordinary amount of 87 percent between the monthly averages for July 1980 and February 1985. (If the appreciation is measured to the peak day of February 25, 1985, the magnitude is 94-1/2 percent.) The Morgan Guaranty measure, which weights the currencies of sixteen foreign countries in proportion to their importance in the trade of the United States (so-called "bilateral" trade weights), shows an appreciation of 54 percent between July 1980 and February 1985 (59 percent to the day February 25).

Developments other than the dollar's appreciation have significantly influenced the U.S. current account. Differences in cyclical conditions here and abroad have been important; as the United States grew more rapidly than other major countries in 1983-84, for example, we correspondingly experienced faster growth in imports, thereby worsening the current account. The United States has a high concentration of exports to developing countries that were hard hit by the world recession and the Third World debt crisis; the troubles of those countries explain some of the decline in the

Figure 4

WEIGHTED-AVERAGE MEASURES OF THE EXCHANGE VALUE OF THE U.S. DOLLAR, 1977-1985



U.S. current account. However, some other developments worked in an offsetting direction. For example, U.S. petroleum imports in the first half of 1985 were fully $30 billion below the rate of the peak year 1980. It is because of the partially offsetting effects of some of the non-exchange-rate developments that analysts ascribe the bulk of the current-account deterioration to the dollar's appreciation.

Why did the dollar soar so high in 1980-84? Economists are unable to give a fully satisfactory answer to this question. Nevertheless, the fiscal-monetary mix in the United States in the 1980s -- a cyclically-adjusted government budget that has become strongly expansive combined with a relatively tight monetary policy -- goes a long way toward explaining why nominal and real interest rates are higher in the United States than abroad. Interest-rate differentials between the United States and other countries, in particular the differential in inflation-adjusted long-term interest rates, can in turn provide a major part of a proximate explanation for the dollar's strength in exchange markets. These fundamental causes of the dollar's appreciation are well understood, and account for most of the rise through the first half of 1984. The uncertainty about the causes of the dollar's strength is greater when one attempts to explain the further appreciation that took place between the summer of 1984 and February 1985.

What might happen in the next few years if the dollar were to stay very strong, with consequently the current-account deficit staying very large and the external-asset position continuing to decline at a rapid rate? Would private foreigners and foreign governments indefinitely add net claims on the United States to their asset portfolios, continuing to transfer a

significant fraction of their savings to the United States and allowing the U.S. claims to form a progressively larger proportion of their wealth? Would Americans find this evolution indefinitely tolerable? Is it imaginable that protectionist pressures pushing for a U.S. reaction to the decline in our traded-goods industries would be continuously kept at bay? My answer to these questions is an unambiguous no.

None of us who have analyzed these trends see a way to identify exactly when or how they will be reversed. But it stretches credibility beyond the breaking point to assert that they could continue for many future years.

If eventually the current-account deficit will have to fall back to a much more modest size with a consequent slowing or even cessation of the accumulation of external debt, a necessary condition will be a substantial depreciation of the dollar. To achieve any given improvement in the current account, moreover, will require an even larger improvement in the trade balance. As can be seen in Figure 1, the non-trade part of the current account is now turning negative. As we rapidly acccumulate external debt, the flow of net interest payments to foreigners will become progressively more negative, in turn forcing the non-trade part of the current account to deteriorate further and further. To restore a current-account position sustainable for the medium and long run, therefore, it will probably be necessary for the United States to run a trade <u>surplus</u>.

The extent of the depreciation of the dollar since it reached a peak in February-March has been substantial. If one measures with the Federal Reserve index, the fall was 17-1/2 percent from the February to the October monthly average (21-1/2 percent from February 25 to October 31). The Morgan Guaranty index, which records smaller movements both up and down than the

Federal Reserve's index, shows a depreciation of 13 percent (16-1/4 percent from February 25 to October 31). As Figure 4 shows, this reversal has brought us back to values for the dollar roughly similar to those prevailing in the second half of 1983.

What Exchange Value for the Dollar Would Lead to a Sustainable External Situation?

How much further would the dollar have to depreciate before reaching a range where -- allowing time for the lagged adjustment in trade flows -- the current-account deficit and the accumulation of external debt would decline to sustainable, acceptable rates?

This important question cannot be answered precisely, for a variety of reasons to which I can only allude here. For one thing, there is no unambiguous way to identify a rate for the current-account deficit that would be sustainable; for example, there is no presumption that the range around zero is obviously the appropriate target. Second, economists do not have precise, reliable estimates of the sensitivity of current-account transactions to exchange rates and other variables; the cautious way to make calculations is to use a range of the available estimates rather than the "best-guess" values of a single researcher. Third, the effects on current-account transactions can be significantly influenced by what causes the dollar to depreciate. For example, the consequences of a depreciation due to policy actions reducing the U.S. budget deficit could be quite different from the consequences of a depreciation attributable to a flight by private investors out of dollar assets into foreign-currency assets. Similarly, calculations can be strongly influenced by projections or assumptions about growth and inflation rates in the United States relative

to those abroad; if foreign growth prospects were unusually bright, for example, U.S. exporters could sell more abroad, and hence the dollar would need to fall less to reach any specified target for the current account. One last important caveat: calculations of the sort I am discussing here are inescapably dependent on particular analytical frameworks and normative assumptions about underlying government policies. Economists do not fully agree on "consensus" models and on which normative assumptions to make. Even in principle, therefore, it is not possible to offer a single, correct calculation of an "equilibrium" or "appropriately aligned" exchange rate.

Nonetheless, under virtually all such calculations with which I am familiar or can imagine, the dollar will have to depreciate substantially further from today's levels to bring the current account and external debt back to a sustainable range. The amount of the improvement necessary in the current-account balance is almost certainly more than $75 billion, and could be well over $100 billion. In order to achieve an improvement of this size, we would have to have at least another 20-25 percent fall in the dollar measured by the Federal Reserve index. This estimate is probably the very low end of the range. The "required" dollar depreciation might have to be as large as 30-35 percent, possibly even 40 percent. Larger figures of this latter size would put the dollar back to, or even somewhat below, the levels observed in 1980.[2]

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2. Since the Morgan Guaranty measure of the dollar's average value tends to move by smaller absolute amounts than the Federal Reserve measure, the range of estimates for "required" depreciation would be proportionately smaller if the calculations were made in terms of the Morgan Guaranty index.

The calculations I am summarizing here, it should be stressed, are not exchange-rate forecasts! Rather, they are analytical judgments about what the dollar would need to do if we were to restore a sustainable situation for the external aspects of the U.S. economy. Many factors I have not mentioned can, and probably will, influence actual exchange-rate developments.

My comments have focused on weighted-average measures of the dollar's exchange value. The numbers one tends to see quoted day by day in newspapers are actual spot exchange rates for individual foreign currencies, for example the yen or the Deutschemark. As an aid to interpreting changes in the dollar's exchange value, therefore, I have included another chart. Figure 5 repeats the two weighted-average measures and also shows what has happened to the DM-per-$ and the yen-per-$ bilateral exchange rates; each index is plotted for the entire period 1970-1985. Plainly, the dollar's value against individual currencies can vary significantly from its average value against all major foreign currencies taken together.

Is the Problem a "Yen Problem"?

One frequently hears it said that Japanese economic policies, or developments in the Japanese economy and exchange rate, are a major cause of the U.S. trade deficit and our unsatisfactory economic situation. Sometimes the charge is made that the Japanese government has held down the external value of the yen. It is even more frequently asserted that the Japanese government should do more to strengthen the yen in exchange markets.

Figure 5

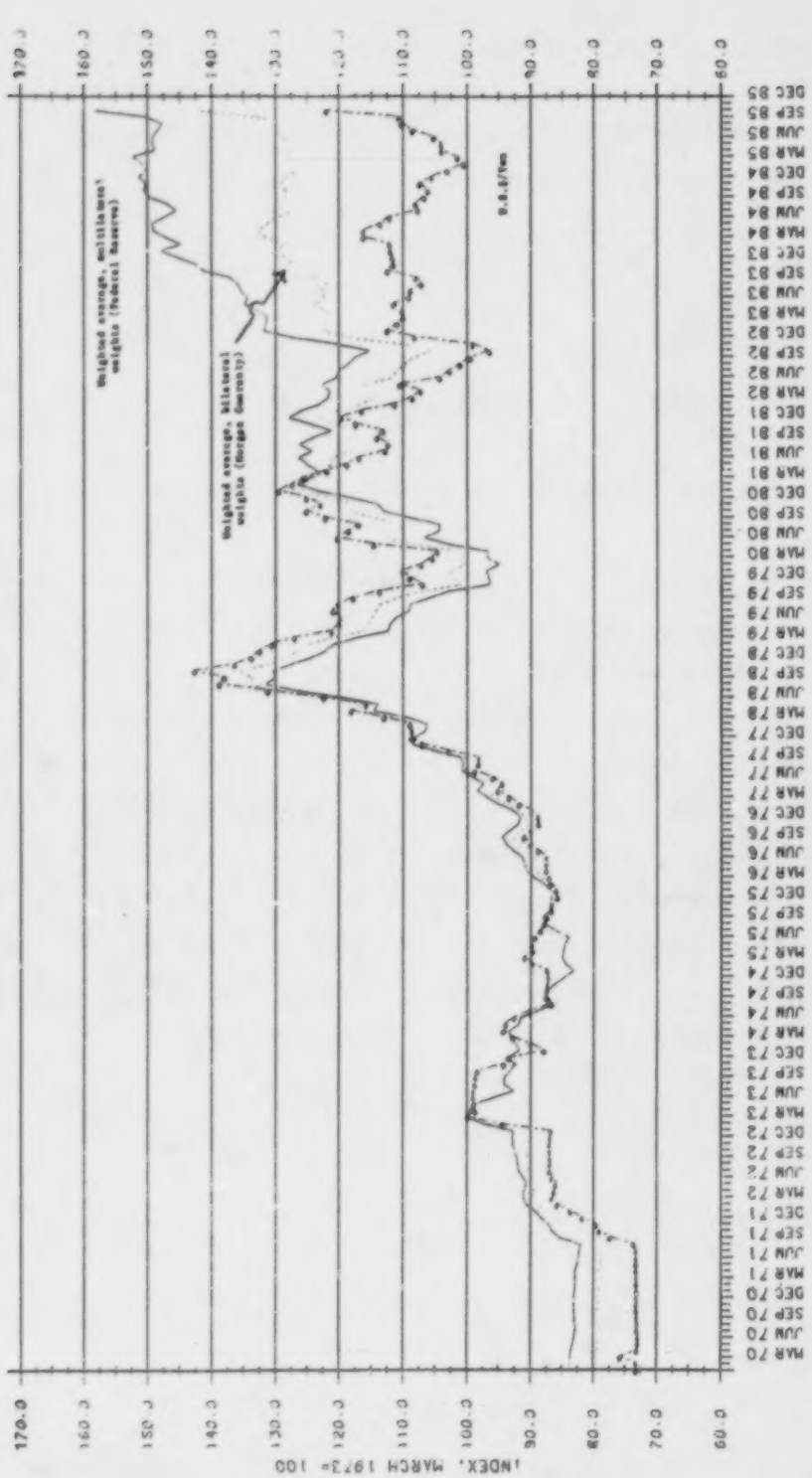
ALTERNATIVE MEASURES OF THE EXCHANGE VALUE OF THE U.S. DOLLAR, 1970-1985

Our economic relations with Japan are not the subject of attention here. In passing, however, I want to alert you to the fact that such contentions about Japan are often based on weak analysis, sometimes even on a lack of awareness of important facts. It is not widely understood, for example, that the Japanese yen has already appreciated by a substantial amount over the last two years. Figure 6 shows three measures of the yen's exchange value analogous to the measures shown for the dollar in Figure 5. Two of the three are weighted-average values against all major currencies. The third curve, the one with asterisks, represents the yen's value against only the U.S. dollar. This chart again brings out the importance of examining average values rather than focusing attention only on the value of a currency against some single other currency. During 1984 when the yen was weak against the dollar, it was nonetheless strong against all currencies taken together. Prior to the sharp further appreciation of the yen since September 22, and even more so in the last few weeks, the average value of the yen has been at historic highs.

Anyone asserting that Japan rather than the United States itself is the primary source of the international difficulties of the American economy seems to me to be making a serious analytical mistake. We have much more of a "dollar problem" than a "yen problem." Furthermore, to treat Japan as a scapegoat for our difficulties -- especially if we were to take or threaten to take protectionist actions against Japan -- could easily cause us to make our own situation worse than it already is.

Figure 6

ALTERNATIVE MEASURES OF THE EXCHANGE VALUE OF THE JAPANESE YEN, 1970-1985


INDEX, MARCH 1973= 100
Weighted average, multilateral weights (Federal Reserve)
Weighted average, bilateral weights (Morgan Guaranty)
U.S.$/Yen

Alternative Short-Run Scenarios: A Sketch of the Possibilities

If we look ahead to the next two years -- say, to the end of 1987 -- we can envisage a variety of possible macroeconomic outcomes. For the purposes of these Hearings, the short-run possibilities can be classified into four groups, as follows:

1. Decisive Pre-Crisis Action to Put the U.S. Budgetary House in Order;
2. The Chickens Come Home to Roost with a Vengeance;
3. Muddle Along without Financial Crisis; and
4. No Sight of the Chickens Coming Home Yet.

I will characterize and comment mainly on the second and third of these possibilities.

Decisive Pre-Crisis Action. As a benchmark, let me first indicate what would be involved in scenario 1. Most important, the President and Congress would cooperate in decisive and convincing actions to put the structural (cyclically adjusted) budget position back on a path toward balance. The Federal Reserve would thereby be able to, and would, pursue a less tight monetary policy. Interest rates in the United States would be lower than they otherwise would have been. For the economy as a whole, the contractionary effects of the fiscal actions would be approximately offset by the expansionary effects of the adjustments to monetary policy. The dollar would depreciate in exchange markets -- because of the desirable change in the U.S. policy mix and the changed financial conditions here relative to those abroad.

The fall in the dollar would be a favorable development for the economy; this policy-induced fall would also reduce the likelihood of a disorderly and precipitous depreciation due to an adverse shift in private confidence. The change in U.S. policies and the fall in the dollar would in turn create opportunities for foreign governments and central banks to adjust their policies. It seems reasonable to believe that foreign governments would respond. If they did not respond, the U.S. policy changes would have contractionary effects on foreign output and employment that foreign governments would find undesirable. The policy changes abroad that would be most appropriate would be some expansionary fiscal action in several major countries. Foreign central banks could also somewhat ease their monetary policies, but preferably would not fully follow the Federal Reserve.

This "Decisive Action" scenario would be unambiguously preferable on economic grounds to all the others. It would be better for the United States. We would resolve the uncertainty about what will otherwise happen to the growth of government debt and the interest burden on future generations of Americans. The prospects for capital formation, productivity, and long-run growth of our economy would be substantially improved. The outcome for other countries in the world would likewise be unambiguously better -- especially so for the heavily indebted countries in the Third World.

What are the chances for this eminently desirable outcome? Unfortunately, at the moment they seem small -- perhaps less than 1 chance out of 10. My guess takes into account the current proposals for Gramm-Rudman type legislation. Indeed, I am so pessimistic partly because

of the disgraceful way that discussion of the Gramm-Rudman proposals have become a substitute for genuine discussions of actual budget actions.

Chickens Come Home to Roost with a Vengeance. What happens in the next two years if only a little -- quite insufficient -- progress gets made on the U.S. budget and policy-mix problem? The most dangerous possibility is a loss of general confidence occurring in conjunction with turbulence in foreign-exchange and domestic financial markets.

In imagining this scenario, I assume that the imbalances and deficiencies in U.S. economic policy characteristic of the last five years, which for the most part have been absorbed phlegmatically by financial markets, suddenly and dramatically become the focus of adverse market attention. It is not possible to predict in advance which event or events would be the trigger for such a sudden re-evaluation. Following the triggering events, however, a perception would quickly develop that the U.S. budgetary situation was out of control and that the political stalemate could not be resolved without a financial-market crisis.

Market participants, in part because they would expect others to try to get out of dollar assets on a large scale thereby driving down the dollar in exchange markets, would try to get out themselves before the others did. Holders of dollar securities, even if not inclined to sell the securities for foreign-currency securities, would nonetheless want to be precautionary too. They would expect sharp upward pressure on U.S. interest rates, and would not be sure how to expect the Federal Reserve to respond to the situation. So as a precaution, they too would sell dollar securities and try to move into liquid dollar assets. As a result of these market shifts, U.S. interest rates would be under sharp upward pressure in the first

instance. Given the increased uncertainty, the stock markets in the United States would probably also fall sharply. The size of the depreciation of the dollar would be large, and the manner precipitous and disorderly. Some possibility exists that individual financial institutions would be seen to be in danger of failing, which would add to the general uncertainty.

If this sequence of events were to occur, the choices facing the Federal Reserve would be very difficult. Its options for domestic monetary policy would fall on a spectrum whose two ends can be described as "accommodate the pressures by leaning strongly against the wind" (open-market purchases that would supply the increased liquidity being demanded throughout the financial markets) and "hang tough" (permitting interest rates to rise as much as necessary to adjust to the market pressures).

If the Federal Reserve chose a policy that accommodated most of the pressures, it would thereby protect against certain types of dangers. The U.S. economy would not experience a sharp rise in interest rates that could tip the economy into recession. Financial intermediaries would not be subject to as much stress; there would thus be a lower probability of failures of financial institutions and the associated worsening of the confidence crisis that could otherwise occur. Such damage protection would also extend to the world economy, which otherwise might be pulled into an induced recession.

A strongly accommodating policy, however, would have its own risks and costs. For one thing, Federal Reserve accommodation would reduce the political heat on the President and the Congress to take prompt action to bring the budgetary process under control. The Federal Reserve might be

perceived by the financial markets as merely validating fiscal irresponsibility and thus laying the ground for a resurgence of inflation. This perception would be one-sided and insufficiently grounded in valid analysis (the accommodation by the Federal Reserve of temporarily high demands for liquidity would only fuel more rapid inflation in the future if the Federal Reserve failed to withdraw the extra liquidity after the crisis and temporary liquidity demands had abated). Nonetheless, this fear could come to be the dominant market view; and if market expectations were sufficiently skittish, offsetting by the Federal Reserve could lead to a downward spiral in confidence.

If the Federal Reserve instead were to hang tough, the arguments pro and con tend to be the opposite of those just mentioned. Under the worst cases, the plunge of the dollar and the upward movement of U.S. interest rates (neither of which would be moderated by the Federal Reserve) could induce a costly recession in output and employment. Not only the U.S. but also the world economy as a whole would be exposed to this risk. The probabilities of failures of financial institutions and the crisis getting worse by feeding on itself would be higher. But the maximum pressure would be kept on the President and the Congress to do something about the budget. Expectations of a resurgence of inflation would be unlikely.

What should the Federal Reserve do in such circumstances? Necessarily, the particular circumstances of the evolving crisis should primarily determine the decisions. As a general guideline, the Federal Reserve should probably steer a middle course, somewhere in between the Strongly Offset and Hang Tough extremes. The less severe the financial-market turbulence, the better grounds there would be for tilting toward Hang Tough. If the economy

seems likely to weaken badly and if individual financial institutions are perceived as in trouble, policy should tack toward offsetting the turbulence.

What are the odds of such a financial crisis actually occurring in the next two years? My guess is that this scenario is not the most likely outcome. Yet it is a distinct possibility -- perhaps with 2 or 3 chances out of 10 of occurring.

Given the dangers, a 20-30 percent chance is a very uncomfortably high probability. We typically take out insurance against likelihoods much smaller than that.

The best insurance possible in the circumstances is a series of steps to bring the U.S. budget back toward a better balance. These steps are highly desirable in any event, but they would in addition unambiguously reduce the probability of the chickens coming home to roost with a vengeance.

There is an old story told about a captain of a sailing ship. He is asked: "What do you do if you find yourself to windward of an island in a typhoon?" His answer, highly pertinent to the policy situation in the United States at the moment, is: "You make damn sure you don't find yourself windward of an island in a typhoon!"

Muddle Along without a Financial Crisis. The characteristics of this class of outcome would involve, in many ways, "more of the same" of what the U.S. economy has experienced in the last several years.

For example, financial markets would continue to be relatively phlegmatic, despite little or no progress on the budget problem. Output and employment would perhaps grow in only a lackluster way, but would hold up

well enough so that we avoid a recession in 1986 and 1987. Interest rates would not rise much, and if they did would rise only gradually. The dollar would probably depreciate somewhat further from its current level. But the decline would not be disorderly; it would probably occur in discrete downward steps, with the dollar then stabilizing for an interim period on each of the steps of the ladder. (The fall in the dollar in the crisis scenario would presumably be much larger and more concentrated in time.) Protectionism would be more or less kept at bay as we muddle along. At some point, say after the summer of 1986, one might even begin to observe a beginning decline in the rate of the current-account deficit (in response to the depreciation of the dollar that began in March 1985).

This muddling-along evolution of the economy seems to me the single most likely outlook for the short run. In probability terms some version of it has a better than 5 out of 10 chance of occurring.

The likelihood of the muddling-along class of outcomes is higher, the smaller is the degree of "misalignment" of the dollar at current levels, and the sooner one can begin to see evidence that the current-account and external-debt developments are moving back toward sustainable paths.

The choices facing monetary policy under Muddle Along scenarios are not comfortable. The Federal Reserve would be subject to all the crosscurrents it has experienced in the last several years. It would still have the thankless task of deciding how to live with the irresponsible budget deficit and how to steer, if possible, between the evils of a recession and the evils of allowing inflation to gain a new lease on life. Its choices, however, would at least be less impossible than they would be in the event of the chickens coming home to roost with a vengeance. Among other things,

the atmosphere in which the Federal Reserve must make its decisions would be less fraught with uncertainty and political tension.

Muddling along for the next two years would not mean that the chickens never come home to roost. On the contrary, the undesirable implications of the government-debt and net-external-debt problems would presumably become more evident as the two years progressed. In a sense, the chickens would start to come home in a gradually increasing trickle -- but not yet disruptively enough to change the politics of the situation or to trigger financial-market turbulence.

No Sight of the Chickens Coming Home Yet. For completeness, we should recognize the small probability that 1986-87 could come with a well-above-average dose of "good luck." (For this scenario, too, I assume that little progress is made in dealing with the U.S. budget deficit.) Such good luck might include buoyant but not excessively rapid growth in the U.S. economy, and also in the world economy. Despite the buoyant growth, there might be no upward market pressure on interest rates. Bullish attitudes about the U.S. economy and the exchange value of the dollar, like the mood in 1984, might prevail; if so, the dollar might strengthen from its current level, or at least not weaken further. Despite the continuation of a very strong dollar and hence a very large present and prospective current-account deficit, foreigners might continue to be willing to transfer a significant fraction of their savings to the United States.

A few economists believe that this sanguine outlook is the most likely scenario for the next two years. I personally think its chances of occurring are relatively small. Moreover, if it did occur, I would regard only part of such an outcome as genuinely constituting "good luck." Buoyant

real growth is fervently to be wished for. But a continued very strong dollar, with all its distortions for the composition of output in the U.S. economy and with its associated rapid accumulation of external debt, would not represent good luck. It would merely aggravate the imbalances that will, later if not sooner, come home to roost. The U.S. economy and the world economy need a further depreciation of the dollar if the U.S. external-debt situation is not to get out of hand and if protectionist actions are to be kept from eroding the world trading system.

Additional Consequences of a Depreciating Dollar

To complete this sketch of alternative outlooks, I want to summarize two important points about the economic consequences we can expect to occur under all the outcomes where the dollar depreciates. The first point concerns inflation in the United States. The second concerns the inevitable consequences of reducing the current-account deficit.

During the recent years that the dollar was appreciating so strongly, the inflation rate in the United States was significantly reduced below what it would otherwise have been. The dollar prices of imports were markedly cheaper. And the prices of import substitutes, U.S. exports, and even the prices of nontraded goods were indirectly dampened. Estimates of the size of this effect vary. But between 1980 and the first half of 1985, the "disinflation gain" for the United States was at least some 3-4 percentage points of inflation (spread over the whole 4-1/2 year period); the gain might have been as large as 6-7 percentage points. These numbers do not of course account for the bulk of the reduction in the U.S. price level relative to the path we were on in 1980. But they were of significant help.

(Conversely, because of the depreciation of their currencies against the dollar, foreign countries experienced less of an inflation reduction than they otherwise would have.)

The point that deserves stress in these Hearings is that a depreciation of the dollar inevitably requires the United States to "give back" some or all of the disinflation gains we earlier enjoyed. The "give-backs" will occur -- indeed, have already started to occur -- whatever the gradualness or abruptness of the depreciation.

The one-time rise in the U.S. price level associated with the depreciation (relative to what the price level would otherwise be) should not be a great cause for concern by itself; in any case that amount of give-back cannot be avoided. What would be a much more serious problem is if secondary effects from the one-time increase fed through to wages, then to price markups, then on to further wage increases, and so on.

Fortunately, the current inflation outlook appears quite tranquil. The years 1986 and 1987 will probably be a relatively good time to experience these inevitable disinflation give-backs.

Suppose that enough of a further dollar depreciation were to occur so that the U.S. current-account deficit began (after the lagged consequences have had time to work themselves through) to decline substantially from its current high rates. Again inevitably, adjustments will then be forced on the domestic economy as the net inflow of foreign savings declines in conjunction with the declining current-account deficit.

The table on the following page provides a convenient framework for grasping some of the consequences of this inevitable adjustment. The identity shown in the table necessarily holds: adjusted savings of the

THE SAVINGS-INVESTMENT IDENTITY IN U.S. NATIONAL INCOME AND PRODUCT ACCOUNTS, 1960-85

Percent of GNP

Period	Adjusted Gross Domestic Savings[a]	+ Federal Government Budget Position[b]	− Adjusted Gross Private Domestic Investment[c]	≡ Net Foreign Investment
1960-69 average	16.31	-0.29	15.54	0.48
1970-79 average	17.96	-1.79	16.17	0.00
1980	17.79	-2.33	15.23	0.24
1981	18.64	-2.17	16.27	0.20
1982	18.14	-4.83	13.52	-0.21
1983	18.64	-5.40	14.26	-1.03
1984	19.77	-4.80	17.51	-2.55
1985 Q1	18.68	-4.33	17.08	-2.73
1985 Q2	19.20	-5.56	16.87	-3.23

Source: Survey of Current Business, September 1985 and previous issues.

a. Personal saving plus business saving (undistributed corporate profits with IVA and CCAdj plus capital consumption allowances with CCAdj) plus wage accruals less disbursements plus the budget positions of state and local governments plus net capital grants received by the United States plus one half of the NIPA statistical discrepancy.

b. NIPA basis.

c. Gross private domestic investment plus one half of the NIPA statistical discrepancy.

private and state-and-local-government sectors plus the federal government's budget position less adjusted domestic investment must always equal net foreign investment.[3] (For convenience of interpretation, the table shows all the variables as a proportion of GNP.)

Consider first scenarios where the federal budget deficit does not come down much if at all. If the current-account deficit is to become less negative, then necessarily either domestic savings would have to rise or domestic investment would have to fall (or some of both). To induce such changes, U.S. interest rates would unambiguously have to rise relative to what they otherwise would have been. This conclusion is the mirror image of the fact that U.S. interest rates in the last several years, because of the large net inflow of foreign savings associated with the current-account deficit, have been lower than they otherwise would have been. The ratio of domestic savings to GNP would not be likely to change by a large amount, even if interest rates were to rise sharply. Probably, therefore, domestic investment would have to assume the main brunt of the adjustment. Investment would have to be "crowded out" by the rise in interest rates, thereby undermining the prospects for long-run growth and productivity.

If the decline in the budget deficit preceded or at least matched the fall in the current-account deficit, there would need to be much less upward pressure on U.S. interest rates and the consequences for domestic investment could be much less injurious.

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3. Except for some accounting details, net foreign investment in the national income and product accounts is equal to the current-account balance in the balance-of-payments accounts.

Exchange-Market Intervention

What role might be played by exchange-market intervention in the various scenarios I have identified?

Such intervention has a potentially helpful role in offsetting frenetic or disorderly market activity. It can sometimes play a helpful role by giving signals to the financial markets about policymakers' diagnoses of the evolving "fundamentals." In principle, intervention can even be used by policymakers to signal intentions about their own policy actions.

The recent shift in the attitude of the U.S. Treasury toward exchange-market intervention -- away from a dogmatic, hands-off stance to a pragmatic approach -- is a welcome, overdue change that merits the support of the Congress.

Similarly, it was a constructive result of the Group-of-Five Finance Ministers meeting in New York on September 22 that they announced they "stand ready to cooperate more closely to encourage some further orderly appreciation of the main non-dollar currencies against the dollar...when to do so would be helpful." From the information currently available, it does appear that intervention has been considerably more active since September 22 than before -- including intervention by the United States authorities.

If we should be unlucky and find ourselves in the Chickens-Come-Home-to-Roost scenario, we may well need the additional flexibility of a pragmatic approach to exchange-market intervention. For example, if the dollar were to start plunging in a precipitous way, it could make sense for the United States and foreign monetary authorities to try to contain the disorder by some strategically timed purchases of dollars. (I do not mean to imply that such intervention should try to prevent the dollar

from falling. Rather, it would have the limited objective of restraining panic market conditions if they should develop. As with domestic monetary policy, either intervention that leaned strongly against the wind or a hang-tough policy that eschewed intervention altogether would have major risks and costs.) Under the more likely Muddle Along scenario, pragmatic intervention can also play a role in restraining strong upward movements of the dollar (via sales of dollar assets) if the depreciation experienced since February 1985 threatens to be reversed.

While intervention can play a useful supporting role, it cannot do more than that. Extensive analysis of intervention operations, carried out both by officials themselves and by academic economists, suggests that intervention which leaves domestic bank reserves unchanged -- so-called "sterilized" intervention -- is not a powerful, reliable instrument with which to influence exchange rates. The very short-run effects may in some circumstances be significant. But there is strong doubt that large, persisting effects will occur.

It would be an illusion -- a dangerous illusion -- to think that such "sterilized" intervention can be a substitute for more fundamental changes in domestic macroeconomic policies. In particular, if anyone in the Administration or Congress were to view aggressive exchange-market intervention as a way of deferring actions to reduce the budget deficit, it would be appropriate to label that view as seriously misguided.

If exchange-market intervention occurs in conjunction with a change in domestic bank reserves -- if the intervention is "unsterilized -- then the effects of the intervention will be much stronger and will persist. But in the United States the scope for easing monetary policy in conjunction with

exchange-market intervention to depreciate the dollar is severely limited by the enormous budget deficit. In the circumstances of the next year or two, therefore, there will be only limited scope for unsterilized intervention unless we can make fundamental progress on the budgetary front.

When the Group-of-Five Finance Ministers met on September 22, they asserted that "fundamental economic conditions" -- including their own policies -- had already improved and would, prospectively, improve further. A few points can be marshalled in favor of the Finance Ministers' strong assertion. For example, in the summer the Congressional budget resolution did make a move in the right direction to reduce the U.S. fiscal imbalance -- though a still modest move in relation to what is needed. And in recent months one or two of the European economies have exhibited somewhat improved growth prospects. By and large, however, the assertion of the Group-of-Five Finance Ministers was more hope than fact. The "fundamentals" are not as auspicious as the language of the September 22 communique suggests.

If one takes into account all the aspects of the economic situation in the Group-of-Five countries, one should be dubious about placing a lot of confidence in the September 22 implied commitment to exchange-market intervention.

The point that exchange-market intervention should not be used as a substitute for needed changes in domestic macroeconomic policies leads naturally to an analogous point about the exchange-rate system itself. We are hearing again much loose talk about holding a new Bretton Woods conference to "reform the international monetary system" -- for example, to make one or another change in the "exchange-rate regime" governing relationships among the major currencies. Unfortunately, many of the

discussions arguing for going back to the fixed-but-adjustable par values of Bretton Woods are 80 percent nostalgia and only 20 percent valid analysis. The supply-side view that argues for a return to a gold standard is weaker still: the proportions there are 125 percent nostalgia and -25 percent valid analysis.

In my view, it is a forlorn hope to look to reform of the exchange-rate regime to produce major improvements in the macroeconomic outlook -- whatever may be the nature of the proposed reform. By itself the manner and degree of exchange-rate variability is not a decisive determinant of macroeconomic outcomes, for good or for ill. Nor is there any change in the exchange-rate regime that can bail us out of our current unsatisfactory economic situation.

The Political Impasse over the U.S. Budget

The economic facts we have been discussing this morning lead inescapably to the conclusion that the country needs its political leaders to take compromise decisions to move the federal budget away from its current out-of-control status. The obvious political difficulty is that, in the country and in Washington, views differ enormously about how to achieve such a compromise: how much to increase tax revenues (and, if so, which tax revenues), and how much to reduce expenditures on government programs (and, if so, which programs).

Common sense says that it is impossible to forge a compromise satisfying all the polar political views and that therefore the collective interest of the country requires each polar view to move toward the center. But here in Washington common sense appears not to be so common. Political

leaders representing the different views are primarily concerned with jockeying for short-run strategic advantage. The name of the game is to avoid blame rather than exerting leadership to arrange the urgently needed compromise.

The latest chapter in this higgledy-piggledy story is the current snafu over the debt limit and the Gramm-Rudman-Hollings legislation. Even the House Democratic version of the Gramm-Rudman idea, while less bad than the Senate version, is a confidence trick: this President and this Congress mandate that the President and the Congress in the future will somehow -- if necessary, mechanically and inefficiently -- do what the current President and Congress do not have the courage and wit to do now.

The most thoughtful analyses of the Gramm-Rudman bills predict that such legislation, if passed, will prove a legal and parliamentary nightmare that would add to uncertainty about budget prospects, not reduce it. This is no time to add uncertainty to what is already a clouded and risky outlook.

As the general public observes the current impasse over the budget, we see the entire political leadership of the country bent over with their ears to the ground, waiting to hear someone else's definition of a political consensus rather than helping to develop that consensus. It is a distinctly uninspiring view!

I am especially critical of the President and his Administration for their failure of leadership. Their position that a tax increase is unnecessary makes a mockery of the idea that the President is the primary individual in the country responsible for articulating the collective national interest.

But the Democratic party deserves almost as much criticism. The Democrats are of course in a difficult position to take the lead in framing a compromise if the Administration will not do its part. Yet the Democrats can at least avoid irresponsible action. Many Democrats in the Congress let themselves be stampeded in 1981 into voting for the Kemp-Roth tax reductions -- a major cause of the current impasse. Until the House vote on November 1, it looked as though something similar might happen with the Gramm-Rudman legislation. What the Democrats will do about the legislation is still in doubt.

Ordinary citizens cannot sufficiently appreciate all the nuances of the political pulling and hauling that is going on. Even so, can it really be that the political constraints are so binding as to make it impossible to identify and implement a genuine compromise on the budget? Cynics say that the art of politics is not to face trade-offs. But that view is too pessimistic. We can reasonably expect more candor and courage from our political leaders -- indeed, more leadership -- than we have recently been getting.

Chairman FAUNTROY. I thank you, Mr. Bryant. I am tempted to launch into a number of questions that your testimony generated, but I am going to remain true to our process and now ask Dr. Frankel if he will make his presentation, and we will have questions following all the witnesses presentations.

Mr. FRANKEL. Thank you, Mr. Chairman.

Chairman FAUNTROY. We have your statement here as well. If you choose to summarize, it might be helpful to us as well.

STATEMENT OF JEFFREY A. FRANKEL, ASSOCIATE PROFESSOR, UNIVERSITY OF CALIFORNIA AT BERKELEY

Mr. FRANKEL. I will abridge my comments.

I, too, find the G-5 initiative of September 22 extremely encouraging. It indicates that the U.S. Treasury now recognizes that the high value of the dollar is a serious problem. There can be no doubt that the tremendous appreciation of the dollar between 1980 and the beginning of 1985 explains more than two-thirds of the $120 billion deterioration in the U.S. trade balance.

Unfortunately, there does not appear to be much increased willingness to address seriously the fundamental cause of the dollar appreciation and trade balance deficit. That cause is the U.S. Federal budget deficit. Whenever the level of funds being used up by a country's budget deficit, plus its physical investment, exceeds funds available from private savings, the difference must be made up by borrowing from abroad. Net borrowing from abroad corresponds to a trade deficit, and I think the last of the tables Ralph Bryant

passed out makes this very clear, the relationship between the components of national savings, including both private and public savings, and investment, and the trade deficit. The way this normally works is that the increase in the budget deficit drives up real interest rates, which attract capital into the country, which in turn causes the dollar to appreciate and worsens the trade balance.

The question I am often asked is: Can anything be done to reduce the trade deficit if we take the budget deficit as given? In particular, does foreign exchange intervention offer a second best policy alternative? I will address first the issue as to whether intervention can succeed in bringing down the dollar, independently of monetary and fiscal policy, and second, whether the effects of such a shift would be overall desirable, assuming it were possible.

The direct effect of intervention operations, swapping domestic for foreign securities, is probably less important than what happens to investors' expectations. Under normal conditions, policymakers can do nothing to change investors' expectations, and thus cannot change the exchange rate, without changing the fundamentals. As of mid-1984 the macroeconomic fundamentals—high real interest rates—provided all the reason needed for a strong dollar. But a funny thing happened between mid-1984 and February 1985. The dollar continued to rise, indeed at an accelerated rate, even though the fundamentals—real interest rates and the trade balance in particular—were, if anything, moving in the opposite direction. It is possible that this 8-month period of dollar appreciation was an instance of a speculative bubble, where market investors buy a currency for no reason other than that they expect the price to go up because everyone else is buying it.

Market participants may simply have lost their moorings. In such circumstances, a decision to undertake foreign exchange intervention can have a significant effect on the exchange rate by pricking the speculative bubble. On these grounds, I consider the September 22 G-5 initiative, and the foreshadowings of it last winter, to have been quite a reasonable way to bring about a moderate decline in the dollar.

But I am not suggesting that at this point policymakers could necessarily expect to engineer a substantial further decline in the dollar, without a change in macroeconomic fundamentals. The dollar is now back down below where it was in 1984 before the speculative bubble, if that is what it was, began. That level, as I have said, can be explained by long-term real interest rates which by various measures remain 3 percent higher in the United States than among our largest trading partners.

If you will turn to the back of my testimony, I have a table there giving long-term interest rates for the United States and our major trading partners. The top panel is nominal rates, the second is expected inflation rates, and the third panel is the difference between the two, the real interest rates; I would in particular draw your attention to the bottom line which is the differential in real interest rates between the United States and a weighted average of our trading partners.

The 1985 real interest differential represents an increase of five points over the differential that prevailed before the dollar began its ascent in 1980, and is just as high as the average for the period

1983–84. I would not rule out as impossible that foreign exchange intervention could cause some further decline of the dollar via the indirect route of investors' expectations. But I consider it more likely that a dollar decline would come about in other ways.

It seems that the question the committee most wants to know the answer to is: What would be the effect on U.S. interest rates if there were a sudden end to the pattern of capital inflow, strong dollar and trade deficit? To answer the question, it is crucial to distinguish between a shift in behavior coming from the Government side and a shift in behavior coming from the side of the private market, that is, to distinguish between a decline in the dollar that would take place as the result of a change in U.S. macroeconomic policy, and a decline that would take place as the result of a change in international investors' expectations or confidence—a portfolio shift.

If the dollar came down as the result of serious progress on the budget deficit, which would be much the preferable circumstance, then real interest rates would fall. Similarly, if the dollar came down as the result of an expansionary monetary policy, though this would be decidedly less preferable because of its inflationary dangers, then again real interest rates would fall. Indeed, one can view monetary or fiscal policy as affecting the real exchange rate only to the extent that it affects the real interest rate.

The answer is very different if the decline in the dollar takes place as the result of a sudden shift in investors' portfolio preferences away from holding dollar assets. Such a shift could come about either because foreigners become alarmed at the ever-growing share of dollars in their portfolios, or because of an increase in perceived risk, or merely because everyone suddenly decides that everyone else expects the dollar to go down. In any case, a decreased desire to hold dollar assets would be reflected in some combination of a decrease in the exchange value of the dollar and a decrease in the price of U.S. bonds, which is the same thing as an increase in U.S. interest rates.

What happens if the dollar declines as the result of foreign exchange intervention, of the sort associated with the G–5 announcement? If the intervention were not sterilized by the Federal Reserve, in other words, if it were allowed to increase the U.S. money supply, then it would be really the case of expansionary monetary policy, which we already saw implied a fall in the real interest rate.

On the other hand, if the Federal Reserve sterilizes the intervention so as to have no effect on the money supply, which is its standard procedure, then interest rates if any thing should tend to rise. In this case the Fed is selling dollar bonds to the public, not dollar reserves. The bonds will have to pay a higher rate of return if the public is to be induced to buy them, the same as when the Fed or Treasury sells bonds under more normal circumstances.

It should be borne in mind that if sterilized foreign exchange intervention has any substantial effect on the exchange rate, it will probably come from the elusive factor of investor expectations or market psychology rather than the direct effect of the actual Fed purchases of foreign currencies. But the implications for the interest rate are the same as with the direct effect—a decreased desire

on the part of investors to hold dollar assets because of expectations of depreciation would probably work to raise interest rates.

The effects I have been discussing concern short-run financial market conditions that can change from day to day. A somewhat more reliable analysis is possible if we ask what would happen to interest rates over the longer term after an abrupt fall in the dollar. The depreciation of the dollar would stimulate production in the exporting and import-competing sectors, indeed, that would be the whole point. The higher production would work to raise the demand for money and credit and thus raise interest rates. Another way to think of it is that we would be shutting off the net capital inflow that is currently helping to keep interest rates down. Without that lending from abroad, domestic savings and investment would be entirely at the mercy of the voracious Federal budget deficit.

How much interest rates would rise depends on how the Federal Reserve reacts to the decline of the dollar. I believe that the Federal Reserve would feel obliged to allow interest rates to rise substantially, both nominal and real, in order to prevent a sharply renewed outbreak of inflation. My own rough estimate is that if the dollar suddenly fell 20 percent, interest rates could rise as much as 3 percent over the course of the subsequent 2 years. Three percent is a big number, but the magnitude is consistent with the increases in real interest rates we have seen in recent years resulting from the loss of saving to the budget deficit.

As a result of the increase in real interest rates along this course, housing starts would probably decline by 300,000, more than $10 billion in residential construction. Nonresidential investment would probably decline by over $35 billion. Including also consumer durables, the total adverse effect on the interest-sensitive components of GNP would be on the order of $50 billion.

I should emphasize again that this is the likely outcome of a 20-percent dollar decline coming from a sudden drying up of the capital inflow from abroad, not from a change in macroeconomic policy. There is no reason to think that a shift of this magnitude will actually happen. A decline in the dollar associated with a fundamental shift in U.S. macroeconomic policy would have interest rate effects of a much more desirable sort.

The favorable effect on the dollar trade balance would not show up in the first year of the lower dollar, because of the famous J curve. But in the second year after a 20-percent depreciation exports would increase by an estimated $33 billion and import spending would fall by an estimated $17 billion in 1985 dollars, for a total trade balance improvement of about $50 billion.

The estimated gain in the trade balance is no larger than the estimated loss in output in the rest of the economy. The shift merely redistributes the crowding out from the exporting and import-competing sectors to other sectors, with little effect on the total. This result is not a coincidence.

The Fed is not targeting real GNP, nor can it, in a world of shifting supply relationships. The Fed is also not strictly targeting the money supply, and properly so, in a world of shifting monetary relationships. It allows the money stock numbers to deviate from the

targets, but only when there is a clear and sustained shift in the velocity of circulation.

In recent years, and in particular in the third quarter of this year, it seems from the letter that Chairman Volcker has just sent Congressman Fauntroy, the Fed has allowed the supply of dollars to grow at a rate above the announced target range in response to the strong demand for dollars, at least as measured by M1. I believe that if there were a fall in international demand for dollar assets, the likely effects on the economy would induce the Fed to try to bring M1 growth back down a little in the direction of the originally announced targets. It is partly for this reason that I believe that a decline in the dollar and improvement in the trade balance would lead to an increase in real interest rates and dampening of investment large enough to net out to approximately zero effect on total GNP.

We come now to the question whether such a decline in the dollar, originating in a sudden portfolio shift and resulting in a mere redistribution of output and employment from some sectors to other sectors, is desirable assuming it is possible. Obviously it depends on whose interests are concerned. Silicon Valley chipmakers and North Carolina textile companies should favor such a shift. Construction companies should oppose it.

Everyone has to judge such tradeoffs for oneself. Personally, 2 years ago I think one could argue that the adverse interest rate implications of such a shift would have dominated. Restoring investment in plant and equipment was supposed to have been a national priority after the 1970's, and investment had instead fallen sharply in the years 1980 to 1983.

It is a close call, but I think that as of 1985 one could argue that the situation was reversed, that such a shift might be desirable if it could be done, that the benefits of a more normally valued dollar would outweigh the costs of the higher interest rates, as high as I have estimated those to be. I have three reasons for thinking so. In the first place, while investment has recovered to the level of 1979, as a share of GNP, the dollar remains at a level higher than it was 2 years ago, and the situation among exporting and import competing industries has become that much more critical. In the second place, the deteriorating trade situation is increasing the danger that the Congress, in desperation, will do something unwise.

The third reason why it might be worth trading off a 20-percent fall in the dollar for a three-percent increase in interest rates is again political. It is relatively easy for the public to see the connection between government borrowing needs and the level of interest rates. The connection to the exchange rate and the trade deficit is less obvious. If interest rates go back up 3 percent, the resulting economic pain may create enough political support for cutting the budget deficit that it could actually be done, not just in the abstract but in the specifics, and not just in the future but in the present. It would be infinitely more sensible to react to the economic pain now coming from the trade problem, by cutting the budget deficit directly. But the indirect route may be more likely politically.

[The prepared statement of Mr. Frankel follows:]

INTEREST RATE EFFECTS OF BRINGING DOWN THE DOLLAR

Statement by Jeffrey A. Frankel
Associate Professor, University of California at Berkeley
Research Associate, National Bureau of Economic Research

before the
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives

November 7, 1985

Views expressed here are those of the author alone, and should not be associated with any organization.

The Policy Shift

I find the G-5 initiative of September 22 extremely encouraging; it indicates that the U.S. Treasury now recognizes that the high value of the dollar is a serious problem. There can be no doubt that the tremendous appreciation of the dollar between 1980 and the beginning of 1985 explains more than 2/3 of the $100 billion deterioration in the U.S. trade balance over that period. The dollar and its lagged effects explain virtually all of the continued $20 billion deterioration of the trade balance this year. It is very hard for U.S. producers to compete with imports whose prices translate into dollar terms at bargain rates, or for U.S. exporters to compete on world markets while charging prices that translate into deutschemark terms at exorbitant rates.

In my reading, the September 22 statement marked, not a mere shift in rhetoric, but a genuine shift in the willingness of the Treasury to undertake coordinated foreign exchange intervention. When I was working for the Council of Economic Advisers last year, the relevant Treasury officials felt that intervening in the market to affect systematically the price of foreign exchange was just as wasteful as intervening in the markets for gold, wheat, or ice cream. But this year, the Treasury took the lead in raising the issue of intervention among the G-5 ministers.

The Two Deficits

Unfortunately there does not appear to be much increased willingness to address seriously the fundamental cause of the dollar appreciation and trade balance deficit. That cause is the U.S. federal budget deficit.

Let us talk in terms of the current account balance, which includes not only merchandise trade but also services and transfers. The current account balance is equal to private saving minus the government budget deficit minus physical investment. If a country has saving left over, after financing its budget deficit and investment, then it runs a current account surplus, as Japan is doing currently, depositing the surplus saving abroad. If the budget deficit and investment exceed the level of saving available, then the country runs a current account deficit, as the United States is doing currently, borrowing from abroad to finance its shortfall. This relationship is not a theory; it is not a long-run tendency; it is not a proposition about which economists may differ. It is a matter of simple arithmetic. If there is an exogenous increase in the budget deficit that is not completely offset by an increase in total private saving or by an equal decline in investment--as it has not been for the United States--then the trade deficit must worsen accordingly. There is no other possibility.

The way this normally works is that the increase in the budget deficit drives up real interest rates, which attract capital into the country, which in turn causes the dollar to

appreciate and worsens the trade balance. In the old days budget deficits only crowded out residential construction, investment in plant and equipment, and other interest-sensitive sectors of our economy. Now, with our system of floating exchange rates and high international capital mobility, budget deficits crowd out exchange-rate-sensitive sectors as much as or more than interest-sensitive sectors.

The question I am often asked is: can anything be done to reduce the trade deficit if we take the budget deficit as given? In particular, does foreign exchange intervention offer a "second-best" policy alternative? I will address first the issue as to whether intervention can succeed in bringing down the dollar, independently of monetary and fiscal policy, and second, whether the effects of such a shift would be overall desirable, assuming it were possible.

Effect of Intervention on the Exchange Rate

International economists begin discussions of intervention by distinguishing according to whether or not the central banks' purchases of foreign exchange reserves are sterilized so as to have no effect on the money supply. If the intervention is not sterilized, so that the purchases of foreign exchange reserves <u>are</u> allowed to increase the money supply, then there is a clear effect on the exchange rate. Increasing the supply of dollars should cause the price of dollars to fall, just as increasing the supply of wheat should cause the price of wheat to fall. But the usual line of reasoning is that if you already have the monetary

policy you want, taking all factors into account, then foreign exchange intervention does not give you a new reason to change it. In the current context, the Federal Reserve does automatically sterilize when it intervenes. (This is not to deny that the Federal Reserve has been conducting monetary policy this year with one eye on the exchange rate. Furthermore the Bank of Japan has clearly accompanied its purchases of yen since September 22 with a monetary tightening.)

Can sterilized foreign exchange intervention have a significant and lasting effect on the exchange rate? Conventional economic analysis says probably not. The argument is that financial markets have become so highly integrated internationally, and so smoothly-operating, that they stand ready to absorb enormous quantities of dollar securities at a given price, without blinking. I share the view that the direct effect of sterilized intervention is likely to be small and transitory.

But there is always the possibility of a larger indirect effect via the expectations of investors in the market. If investors expect the dollar to go down, they will of course sell dollars and the value of the currency will fall as soon as the do. This is what happened the morning after the September 22 announcement of the G-5 meeting: the dollar instantly fell five percent.

Under normal conditions policy-makers can do nothing to change investors' expectations, and thus cannot change the exchange rate, without changing the fundamentals. As of mid-1984 the macroeconomic fundamentals--high real interest rates--

provided all the reason needed for a strong dollar; there was no reason why investors should expect a sudden large decline. But a funny thing happened between mid-1984 and February 1985. The dollar continued to rise, indeed at an accelerated rate, even though the fundamentals (real interest rates and the trade balance, in particular) were if anything moving in the opposite direction. It is possible that this eight-month period of dollar appreciation was an instance of a "speculative bubble," where market investors buy a currency for no reason other than that they expect the price to go up because everyone else is buying it.

One way such a bubble could have gotten started in 1984 is if the "fundamentalist" forecasters had been driven out of the marketplace, leaving only the "chartists." The fundamentalists are the ones who for several years have been forecasting a gradual decline of the dollar based on forecasts of declining real interest rates and the mounting trade deficit. The chartists are the forecasters who just extrapolate recent trends. For several years in a row it happened that the dollar behaved contrary to the forecasts of the fundamentalists. I find it plausible that as a result, by late 1984, investors had stopped paying attention to those forecasts and were instead going with the chartists' extrapolation of dollar appreciation.

In any case, it is difficult to identify the final months of the dollar's dizzying climb with any movement in economic fundamentals. Market participants may simply have lost their moorings. In such circumstances a decision to undertake foreign

exchange intervention, even sterilized, can have a significant effect on the exchange rate by pricking the speculative bubble. As Paul Krugman of M.I.T. has said, the market might react to intervention as to a slap in the face: "Thanks. I needed that!" On these grounds, I consider the September 22 G-5 initiative, and the foreshadowings of it last winter, to have been quite a reasonable way to bring about a moderate decline in the dollar.

But I am not suggesting that at this point policy-makers could necessarily expect to engineer a substantial further decline in the dollar, without a change in macroeconomic fundamentals. The dollar is now back down below where it was in 1984 before the speculative bubble, if that is what it was, began. That level, as I have said, can be explained by the level of long-term real interest rates, which by various measures remain three percent higher in the United States than among our largest trading partners. This real interest differential represents an increase of five points over the differential that prevailed before the dollar began its ascent in 1980, and is just as high as the average for the period 1983-84. It is extremely unlikely that all five years of dollar appreciation are attributable to a speculative bubble that remains to be burst.

I would not rule out as impossible that foreign exchange intervention could cause some further decline via the indirect route of investors' expectations. But I consider it more likely that a dollar decline would come about in other ways.

Effect on Interest Rates of a Dollar Decline

What would be the effect on U.S. interest rates if there were a sudden end to the pattern of capital inflow, strong dollar, and trade deficit? To answer this question, it is crucial to distinguish between a shift in behavior coming from the government side and a shift in behavior coming from the side of the private market, that is, to distinguish between a decline in the dollar that would take place as the result of a change in U.S. macroeconomic policy, and a decline that would take place as the result of a change in international investors' expectations or confidence (a "portfolio shift").

If the dollar came down as the result of serious progress on the budget deficit, which would be much the preferable circumstance, then real interest rates would fall. Similarly, if the dollar came down as the result of an expansionary monetary policy, though this would be decidedly less preferable because of its inflationary dangers, then again real interest rates would fall. (Nominal interest rates would rise, after enough time had elapsed for them to reflect higher expectations of inflation.) Indeed one can view monetary or fiscal policy as affecting the real exchange rate only to the extent that it affects the real interest rate.

The answer is very different if the decline in the dollar takes place as the result of a sudden shift in investors' portfolio preferences away from holding dollar assets. Such a shift could come about either because foreigners become alarmed at the ever-growing share of dollars in their portfolio, or

because of an increase in perceived risk, or merely because everyone suddenly decides that everyone *else* expects the dollar to go down. In any case, a decreased desire to hold dollar assets would be reflected in some combination of a decrease in the exchange value of the dollar and a decrease in the price of U.S. bonds, which is the same thing as an increase in U.S. interest rates.

What happens if the dollar declines as the result of foreign exchange intervention, of the sort associated with the G-5 announcement? If the intervention were not sterilized by the Federal Reserve, in other words if it were allowed to increase the U.S. money supply, then it would really be the case of expansionary monetary policy, which we already saw implied a fall in real interest rates. It is the same regardless whether the Federal Reserve puts more money in the hands of the public by buying Treasury securities from them, which is the usual procedure, or whether it puts more money in the hands of the public by buying foreign currencies from them, which is what we mean by nonsterilized foreign exchange intervention.

On the other hand, if the Federal Reserve sterilizes the intervention so as to have no effect on the money supply, which is its standard procedure, then interest rates if anything should tend to *rise*. In this case the Fed is selling dollar bonds to the public, not dollar reserves; the bonds will have to pay a higher rate of return if the public is to be induced to buy them, the same as when the Fed or Treasury sells bonds under more normal circumstances.

It should be borne in mind that if sterilized foreign exchange intervention has any substantial effect on the exchange rate, it will probably come from the elusive factor of investor expectations or market psychology rather than the direct effect of the actual Fed purchases of foreign currencies. But the implications for the interest rate are the same as with the direct effect; a decreased desire on the part of investors to hold dollar assets because of expectations of depreciation would probably work to raise interest rates.

The effects I have been discussing concern short-run financial market conditions that can change from day to day. A somewhat more reliable analysis is possible if we ask what would happen to interest rates over the longer term after an abrupt fall in the dollar. The depreciation of the dollar would stimulate production in the exporting and import-competing sectors; indeed that would be the whole point. The higher production would work to raise the demand for money and credit, and thus raise interest rates. Another way to think of it is that we would be shutting off the net capital inflow that is currently helping to keep interest rates down; without that lending from abroad, domestic saving and investment would be entirely at the mercy of the voracious federal budget deficit. It would be the same if we induced Japan and Europe to raise their interest rates to discourage capital from flowing here, or if we put on capital controls that could somehow magically block the flow. If foreigners stop putting their savings in the United States, for whatever reason, it will work to push up interest rates.

How much interest rates would rise depends on how the Federal Reserve reacts to the decline of the dollar. I believe that the Federal Reserve would feel obliged to allow interest rates to rise substantially (both nominal and real) in order to prevent a sharply renewed outbreak of inflation. My own rough estimate is that if the dollar suddenly fell 20 percent, interest rates could rise as much as 3 percent (300 basis points) over the course of the subsequent two years. This calculation assumes that the Fed chooses a middle course. If it did not react with any change in monetary policy, the interest rates would rise by significantly less. At the opposite extreme, if it sought to prevent the higher import prices from putting any upward pressure on the CPI at all, real interest rates would rise even more than in my estimate. Three percent is a big number, but the magnitude is consistent with the increases in real interest rates we have seen in recent years resulting from the loss of saving to the budget deficit.

As a result of the increase in real interest rates along this middle course, housing starts would probably decline by 3 hundred thousand (more than $10 billion in residential construction). Nonresidential investment would probably decline by over $35 billion. Including also consumer durables, the total effect on the interest-sensitive components of GNP would be on the order of $50 billion.

I should emphasize again that this is the likely outcome of a 20 percent dollar decline coming from a sudden drying up of the capital inflow from abroad, not from a change in macroeconomic

policy; there is no reason to think that a shift of this magnitude will actually happen. A decline in the dollar associated with a fundamental shift in U.S. macroeconomic policy would have interest rate effects of a much more desirable sort.

Effect on Total GNP

The favorable effect on the dollar trade balance would not show up in the first year of the lower dollar, because of the famous "J-curve." But in the second year after a 20 percent depreciation exports would increase by an estimated $33 billion and import spending would fall by an estimated $17 billion (in 1985 dollars) for a total trade balance improvement of about $50 billion.

The estimated gain in the trade balance is no larger than the estimated loss in ouput in the rest of the economy. The shift merely redistributes the crowding out from the exporting and import-competing sectors to other sectors with little effect on the total. This result is not a coincidence. In the long run our economy's total potential output is constrained by such factors as our technology and the size of our labor force, capital stock, and natural resources. Even in the short run, when output can fall below potential, it is nonetheless constrained by the necessity of preventing a revival of inflationary pressures.

The Fed is not targeting real GNP; nor can it, in a world of shifting supply relationships. The Fed is also not strictly targeting the money supply, and properly so in a world of

shifting monetary relationships. It allows the money stock numbers to deviate from the targets, but only when there is a clear and sustained shift in the velocity of circulation. During the past year the Fed has allowed the supply of dollars (M1) to grow at a rate above the announced target range, in response to the strong demand for dollars.

I believe that if there were a fall in international demand for dollar assets, the likely effects on the economy would induce the Fed to try to bring M1 growth back down a little in the direction of the originally announced targets. It is partly for this reason that I believe that a decline in the dollar and improvement in the trade balance would lead to an increase in real interest rates and dampening of investment large enough to net out to approximately zero effect on total GNP.

Desirability of Such a Shift

We come now to the question whether such a decline in the dollar, originating in a sudden portfolio shift and resulting in a mere redistribution of output and employment from some sectors to other sectors, is desirable assuming it is possible. Obviously it depends on whose interests are concerned. Silicon Valley chip-makers and North Carolina textile companies should favor such a shift. Construction companies should oppose it. In many industries--automobiles, farm equipment, agriculture, and mining--it is hard to know whether the very favorable effect of a 20 percent fall in the dollar would be more or less important than the very unfavorable effect of a 3 percent increase in interest rates.

Everyone has to judge such tradeoffs for oneself. Personally, two years ago I think one could argue that the adverse interest rate implications of such a shift would have dominated. Restoring investment in plant and equipment was supposed to have been a national priority after the 1970s, and investment had instead fallen sharply in the years 1980 to 1983. If one took it as given that the rapidly growing structural federal budget deficit was going to be crowding out other sectors of the economy, it seemed only fair that the exchange-rate-sensitive sectors would share in the discomfort as much as the interest-rate sensitive sectors. Even assuming that one could somehow have forced the dollar down without a change in macroeconomic fundamentals, there was not an obvious case for doing so as of 1983.

It is a close call, but I think that as of 1985 one could argue that the situation has reversed, that such a shift might be desirable if it could be done, that the benefits of a more normally valued dollar would outweigh the costs of the higher interest rates, as high as I have estimated those to be. I have three reasons for thinking so. In the first place, while investment has recovered to the level of 1979 (as a share of GNP), the dollar remains at a level higher than it was two years ago, and the situation among exporting and import-competing industries has become that much more critical.

In the second place, the deteriorating trade situation is increasing the danger that the Congress, in desperation, will do something unwise. Under our system, if a manufacturer falls

victim to a shift in consumer buying patterns, he may get our sympathy, and any workers he lays off may get unemployment compensation, but there is not a whole lot more we can do for him. The same is true if the manufacturer falls victim to a shift in government buying patterns, or even to an increase in interest rates resulting from a U.S. government budget deficit. But, under our system, if a manufacturer falls victim to a flood of imports, he may be able to get protection from the government in the form of trade barriers, even when the imports are entirely attributable to the exchange rate and the same U.S. government budget deficit. Such protectionist barriers usually succeed in helping the industry in question, but they hurt virtually all other Americans: consumers who have to pay higher prices, other industries who use the imported commodity as an input, and exporters who lose their foreign customers, especially in the event of retaliation by our trading partners. If the strong dollar results in the erection of new trade barriers, the effect on total GNP will <u>not</u> "net out," but will be damaging for years to come.

The third reason why it might be worth trading off a 20 percent fall in the dollar for a 3 percent increase in interest rates is again political. It is relatively easy for the public to see the connection between government borrowing needs and the level of interest rates. The connection to the exchange rate and the trade deficit is less obvious. If interest rates go back up by 3 percent, the resulting economic pain may create enough political support for cutting the budget deficit that it could actually be done, not just in the abstract but in the specifics, and not just in the future but in the present. It would be infinitely more sensible to react to the economic pain <u>now</u> coming from the trade problem, by cutting the budget deficit directly. But the indirect route may be more likely politically.

NOMINAL AND REAL INTEREST RATES OF THE UNITED STATES
AND ITS TRADING PARTNERS

	1980 Average	1981-2 Average	1983-4 Average	mid 1984	Feb 1985	July 1985
(1) Long term Nominal Interest Rates						
US	11.39	13.32	11.91	13.54	11.70	10.68
Wtd. Avg. of Trading Partners	11.34	12.47	10.19	10.24	9.33	8.79
UK	13.79	13.81	10.75	11.15	11.07	10.44
FR	12.99	15.61	13.01	12.96	11.42	10.67
WG	8.50	9.67	7.83	8.10	7.40	6.70
IT	16.11	20.74	16.48	14.89	12.36	13.28
CA	12.48	14.74	12.27	13.81	12.30	10.91
JA	9.22	8.36	7.12	7.12	6.79	6.20
Differential, US - Wtd. Avg.	0.05	0.84	1.72	3.30	2.37	1.89
(2) Three Year Weighted Inflation Rates						
US	11.67	10.20	4.94	4.32	3.83	3.51
Wtd. Avg. of Trading Partners	9.35	9.40	6.31	5.60	4.92	4.77
UK	14.69	12.77	6.44	5.48	5.34	5.62
FR	11.68	12.72	10.05	9.18	7.72	7.16
WG	4.54	5.48	3.88	3.57	2.98	2.50
IT	17.45	18.03	14.50	13.37	11.48	10.91
CA	9.60	11.15	7.37	5.97	5.01	4.28
JA	5.85	4.99	2.45	1.98	1.95	2.42
Differential, US - Wtd. Avg.	2.32	0.80	-1.37	-1.28	-1.08	-1.26
(3) Long Term Real Interest Rates (1) - (2)						
US	-0.28	3.12	6.97	7.22	7.87	7.17
Wtd. Avg. of Trading Partners	1.99	3.08	3.88	4.64	4.41	4.02
UK	-0.91	1.04	4.31	5.67	5.73	4.82
FR	1.31	2.89	2.96	3.78	3.70	3.51
WG	3.96	4.18	3.95	4.53	4.42	4.20
IT	-1.34	2.70	1.98	1.52	0.88	2.37
CA	2.88	3.59	4.90	7.84	7.29	6.63
JA	3.37	3.37	4.67	5.14	4.84	3.78
Differential, US - Wtd. Avg.	-2.27	0.04	3.09	4.58	3.46	3.16

Notes: Nominal interest rates are long-term government bond rates from the IMF, line 61. Long term expected inflation is a weigted average of (CPI) inflation rates over the past 3 years, weighted .5, .3, .2. Trading Partner weights are 1980 GNP weights from the OECD Economic Outlook. For real interest differentials based on alternative measures of expected inflation, see J. Frankel, "The Dazzling Dollar," Brookings Papers on Economic Activity 1985,1; or "Six Meanings of 'Overvaluation': The 1980-85 Dollar" Essays in International Finance, Princeton, Dec. 1985.

Chairman FAUNTROY. Thank you so much, Dr. Frankel. Again, we have questions we want to tender to you, but we will proceed with the others on the panel.

Dr. Karczmar, we would be pleased to have your presentation at this time. Again, as you can, we would appreciate your summarizing.

STATEMENT OF MIECZYSLAW KARCZMAR, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, EUROPEAN AMERICAN BANK

Mr. KARCZMAR. Thank you, Mr. Chairman.

I guess I belong to this group of economists to which Congressman McCollum referred to as the statisticians. Anyway, I am going to present to you a different view from both that which was presented at this meeting before me and from that which you might read about extensively in economic comments and in the press.

I am not sure if I would qualify myself as a statistician, I am not a statistician, as a matter of fact. Anyhow, I do not agree with the standard reasoning which creates this chain of reasoning. The root cause is the budget deficit; the budget deficit drives interest rates up; higher interest rates drive the dollar up; and the higher dollar hurts our foreign trade and creates trade deficits.

As a matter of fact, I do not agree with any one of these segments of reasoning. First, there is no correlation between the dynamics of the budget deficit and the trend in interest rates. I don't think this needs illustrating by numbers. The fiscal deficit has exploded in the last few years, but interest rates have dropped.

Of course, one can argue that if not for the budget deficit and the consequent demand for credit by the Government, interest rates would have been lower. But it doesn't explain at all the causal relationship. In fact, many other factors have been much more important, and they have overwhelmed the theoretical effect of rising budget deficit on interest rates. Afer all, I think it is no accident that if you look around the globe you will find that the countries which have generally low fiscal deficits and a low level of interest rates are the countries with traditionally stronger currencies, not weaker currencies.

Even less convincing is the argument that high and rising interest rates have been responsible for the dollar's strength. It is only true from a short term perspective of the foreign exchange trader who sees that when interest rates go up he might expect the dollar to strengthen, and vice versa, but in the longer run, this doesn't hold. The changes have been highly asymmetrical.

Over the past 5 years the dollar has tended to appreciate more than proportionately when interest rates were on an upswing and depreciate less than proportionately when they were falling. As a result, in a longer perspective, interest rates and exchange rates have been moving in opposite directions. This is illustrated in annex 1 to my paper, where you see that 5 years ago the prime rate was 21½ percent. It is now 9½ percent. But during this 5-year period the dollar has strengthened very significantly.

Now, there is another sort of reasoning, a more sophisticated one, which says it is not just interest rates, but interest rate differentials between countries, which really affect the exchange rate.

This is also not entirely true. The average differential between the Eurodollar and Euromark short-term deposits over the 1981-84 period, was about 4½ percentage points in favor of the dollar. If somebody wanted to take advantage of this differential and shifted his money from marks to dollars he would have earned about 22½ percent compounded, but during that period of time the dollar strengthened vis-a-vis the mark by over 60 percent. It is clear, there were other more important factors which pushed the dollar up.

There is another view which associates the rise in the dollar, or changes in exchange rates in general, with the type of monetary policy the country is following. For example, some economists say that it was the shift of the Federal Reserve to a monetarist-oriented monetary policy in October 1979 that turned around the dollar from a weak to a strong currency. But this is again not true. As we all know, this monetarist approach ended sometime in mid-1982, but the dollar still continued to rise very strongly for another 3 years.

In short, it is not the budget deficit nor the interest rates behavior nor monetary policy that pushed the dollar up. In my view, the three most important reasons why the dollar did appreciate so strongly and contrary to most people's expectations were:

First, the sharp drop in U.S. inflation. Second, the strength, dynamism and flexibility of the American economy that contrasted sharply with a generally sluggish performance in other industrial countries and with the financial crises in many developing countries. Third, political considerations, projecting the United States as a politically stable country and a relatively safe place for international investments. These three factors combined led to a strong inflow of foreign capital into the United States as well as to a drastic cut in capital outflow from the United States, which created a scarcity of dollars in international credit markets.

Another important point which I do not agree with is the standard view about the relationship between the dollar's appreciation and the trade deficit. Indeed, the rise in the trade deficit coincided in time with the dollar's appreciation, but if you analyze the geographical structure of the deficit you will find that the impact of the rising dollar was rather insignificant.

For example, the combined deficit in 1983 and 1984—and these were the 2 years when the deficit really exploded—was about $170 billion, out of which $53 billion or about 31 percent was vis-a-vis Japan. However, the exchange rate between the yen and the dollar didn't change much during this period. This is illustrated in annex 2 to my paper where you see the relationship between the United States, Japan and trade deficit and the fluctuations of the exchange rate. The exchange rate between the dollar and the yen on the whole changed very little during these 5 years, but the deficit exploded.

Even those economists who strongly contend that it is the exchange rate of the dollar that produced our trade deficit would agree that this hardly applies to Japan. There were many other factors which did create this situation, like difficult access of our goods to the Japanese market, low domestic consumption there, high quality of Japanese products, and their lower production

costs. These are reasons why Japan has had surpluses with the United States and for that matter, with almost all other countries.

It is worthwhile to mention that we had an uninterrupted string of trade deficits with Japan for the past 20 years, even though during these 20 years the dollar was both strong and weak.

Then when you look further you will see that another 20 percent of the deficit, was with Canada. But here again, the exchange rate didn't change much. About 22½ percent of the deficit was versus countries whose currencies are pegged to the dollar, they move in unison with the dollar, countries like Taiwan, South Korea and so on.

Finally, about 12½ percent of the deficit was with Mexico and Brazil. Of course, the exchange rates of their currencies have dropped sharply, but this had nothing to do with the strength of the dollar. Our deficit with these countries was simply due to the financial crisis there. They were desperate to export and we didn't export to them. So if you add it all up, you will find that over 85 percent of our total trade deficit over the past 2 years was with countries where there was very little or no appreciation of the dollar or where the appreciation didn't play any role. There were other important reasons that produced that deficit:

First, at the beginning of this rising deficit trend, it was the collapse of our exports to Latin America;

Second, in the last 2 years, it was the disparity of economic growth between the United States and the rest of the world that was mainly responsible for the trade deficit.

Finally, there was a host of other reasons that were completely independent of exchange rate fluctuations, which would have produced a deficit regardless of what would have happened to the exchange rate. Reasons like progressing obsolescence of our industrial plant; higher relative labor costs; increasing world grain outputs, which has significantly reduced demand for U.S. grain; improving quality of foreign products, and so forth.

In short, what I am trying to say is that by knocking the dollar down we are not likely to reduce the trade deficit significantly. We may make some dent, but this is not likely to solve the deficit problem.

I read the G-5 agreement mainly as an attempt to address the protectionist person and to try to reduce the trade deficit, and as I mentioned, this is not something which is going to happen.

I would like now to stress strongly the importance of psychological factors in the G-5 agreement. In my view, it is not so much actual intervention, but rather the threat of intervention, which tends to push the dollar down. That is what I call in my paper attempts to talk the dollar down.

It was mentioned before that the dollar dropped by about 15 percent from its February 1985 peak prior to the G-5 agreement. Now, when you analyze the reasons why the dollar dropped by about 15 percent, in my view it was mainly because there were strong attempts at that time—between February and September—to talk the dollar down, especially attempts coming from our more influential policymakers.

For example, the critical point in pushing the dollar down in late February 1985 was Mr. Volcker's statement, in which he clearly

showed his irritation with the strong dollar, that it does limit his ability to pursue monetary policy based on domestic considerations alone, and the dollar dropped sharply as a result of this statement.

The dollar dropped further when the Secretary of the Treasury a few weeks later said publicly that he was not displeased with the dollar's drop. This of course changed the psychology of foreign exchange markets. It created a situation where the foreign exchange markets positioned themselves accordingly. When they see that the U.S. Government itself is interested in reducing the value of its own currency, then of course it is an easy game for them.

I do agree with other witnesses who did mention that intervention alone is not likely to have lasting affects if it is not supported by fundamental changes in economic policies. And reportedly this is something which has been agreed under the G-5 agreement. Most importantly, the other countries were supposed to change their economic policies toward a more stimulative posture. This would have been a very good outcome, but immediately after the agreement they strongly denied that they have any intention to change their policies.

Theoretically, to essentially change an exchange rate relationship between two currencies one has to inflate the economy of the country which is interested in pushing its currency down, and or to deflate the economy of the country which wants to appreciate its currency. I think that hardly anyone would advocate putting the U.S. economy back on an inflationary track, but that is what would be theoretically required of us, and that is what is inevitable if the dollar indeed were to depreciate.

Even more contradictory is the relationship on the other side. The other industrial countries would have to deflate their economies. But that would be sheer nonsense from their point of view because their economies are sluggish, unemployment there is at very high levels, and inflation is disappearing.

Altogether, I see four major negative consequences of the dollar's depreciation. First, and probably the most important, is the negative shift in the terms of trade. Terms of trade is a concept infrequently debated, I should say even ignored in our economic debates. It is probably no accident that in the testimony today the term hasn't been even mentioned. This is a very important concept, indicating the relationship between the changes in export and import prices.

Deterioration in the terms of trade, which is inevitable with a falling currency, in effect means that a country will spend more of its own output to acquire a unit of imports. It will simply become poorer. A negative shift in the terms of trade is fully comparable to a loss in productivity. Nonetheless, countries from time to time resort to currency devaluation even though this would deteriorate the terms of trade. The reason is they hope that the response on the real side of trade flows will quickly offset the negative impact of the deteriorating terms of trade, and improve the trade balance.

But this does not apply, in my view, to the United States because of the specific structure of our exports, which on the whole are not very price sensitive and also because of the characteristics of our imports, which have high income elasticity, and low price elasticity. You have read today in the papers that Japanese exporters of

television sets and other electronic goods have announced that they are raising their prices in the American market, because of the decline of the dollar vis-a-vis the yen. Would this limit our imports from Japan and improve our trade balance?

Do you really expect that Americans will stop buying Japanese television sets or cameras or tape recorders and so on? Of course not. They will continue buying them because these are high quality products. Americans like them. So they will continue buying them and they will pay higher prices. And these higher prices will be immediately translated into higher prices of domestically produced goods competing with imports. Already Zenith Electronics announced they also are going to raise prices.

So once it pays higher prices the public will demand higher wages. Higher wages will feed into higher prices and you have unleashed a new wave of inflation.

Chairman FAUNTROY. We have followed your conclusions and you have now moved through your second negative effect, and we note that you are going to note as you have already, rising inflation, and the upward trend in interest rates. I wonder if you could, for the sake of time and to allow us to hear the whole panel, would you go to your conclusion for us?

Mr. KARCZMAR. Yes, Mr. Chairman.

As I mentioned, the first negative is a deterioration of the terms of trade; the second is increasing difficulties in financing the balance of payments deficit; the third is the inflationary impulse, although here I would expect that the inflationary response will be delayed in general, because foreign exporters will try to preserve their market shares, and they will tend to trim their profit margins rather than raise prices. But this is only a matter of time. The inflationary effect is inevitable.

Finally, of course, this would lead to an upward trend in interest rates both because of the impaired inflow of foreign capital and because of the inflationary effect, and this would happen even if monetary policy remained neutral.

Chances are, though, that monetary policy is not going to remain neutral. Most likely, the Fed will try to prevent a steep fall of the dollar and the resulting inflation, and therefore will push interest rates up.

In my final conclusions, I personally view the G–5 agreement as a mistake. It is not likely to achieve its main goal, which is to correct the U.S. trade deficit, but would create serious problems instead.

[The prepared statement of Mr. Karczmar follows:]

THE DOLLAR AND THE U. S. ECONOMY

Statement by

Mieczyslaw Karczmar
Senior Vice President and Chief Economist
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Before

the Subcommittee on Domestic Monetary Policy of the
Committee on Banking, Finance and Urban Affairs
of the U.S.House of Representatives
November 7, 1985

Causes of the dollar appreciation

In order to fully understand the possible impact of a weaker dollar on the economy and interest rates, it is necessary to examine the causes and effects of the dollar's rise during the 1980-1984 period. According to conventional wisdom, it is the particular mix of American economic policy - loose fiscal policy and tight monetary policy - that has been responsible for the strong dollar.

The standard reasoning goes like this: The root cause of the rising dollar exchange rate has been the fiscal deficit. It has driven up U.S. interest rates or kept them at higher levels than justified by the receding inflation rate. Excessively high interest rates have been the main factor in raising the dollar's value. This, in turn, has hurt our export and import-competing industries and has led to huge trade and current-account deficits.

There are serious flaws and misconceptions in this reasoning with regard to both the causes and effects of the dollar's appreciaton.

- There is no empirical evidence that budget deficits necessarily lead to rising interest rates. It depends on the cyclical situation and the way the deficits are financed. In fact, in U.S. postwar history expanding budget deficits were associated with declining rather than rising interest rates. Our recent experience is a good case in point. Budget deficits have risen sharply over the past several years, but interest rates have fallen. True, one can logically argue that if it were not for the rising fiscal deficits, interest rates would have been lower than they are. But this does not mean that lower deficits would bring down interest rates. Many other factors affect interest rates, and they may well overwhelm the influence of the Government credit demand as they did in the past.

- Even less convincing is the proposition that high or rising U.S. interest rates have been responsible for the dollar's strength. It is true that in the short run the dollar tends to strengthen when U.S. and Eurodollar interest rates move up or when it is anticipated that monetary policy will be tightened due, e.g., to an acceleration in money supply growth. And vice versa, the dollar tends to weaken when interest rates fall or money supply statistics imply that easier credit conditions may be forthcoming. These movements have been, however, highly asymmetrical. The dollar has been appreciating more than proportionately when rates have been rising and depreciating less extensively when they have been falling. Consequently, in the longer

run, interest rates and exchange rates have been moving in opposite directions. This can be clearly seen in the accompanying chart (Annex 1). At the end of 1980, the prime rate stood at 21 1/2%; it has dropped since then by more than one-half, but the dollar has risen sharply even when allowing for its recent weakening. Paradoxically, to some extent, the decline in interest rates has been pushing the dollar up rather than down. The decline has been tantamount to rising bond prices and has contributed to a strong upturn in the stock market, both factors attracting foreign capital to the United States.

- Also, when trying to explain the dollar's behavior by interest rate differentials relative to other currencies, one can hardly find a clear correlation. For example, during the 1981-1984 period the rate differential between the Eurodollar and Euromark short-term deposits averaged about 4.5 percentage points. An investor who wanted to take advantage of this difference and shifted his money from DMarks to dollars would have gained about 22.5% compounded. But the dollar rose by 60% vis-à-vis the DMark during that time. Obviously, other factors played a more important role.

- Some economists contend that the rising dollar trend has been related to the Federal Reserve's shift to monetarism in October 1979. They argue that it was the new policy of influencing the money supply rather than interest rates that turned the dollar around from a weak to a strong currency. This contention is also not supported by

evidence. The shift to monetarism did not prevent the dollar from declining for another nine months before the trend reversed itself. More importantly, the dollar continued to rise for about three years after the Fed practically abandoned its strict monetarist approach in mid-1982.

- Another view, widely held by monetarist-oriented economists, has it that it is growth of the money supply that determines exchange rate trends. According to this view, countries which follow a policy of slow and steady money growth have appreciating currencies, and vice versa. However, this proposition is also not confirmed by facts. Over the five-year period, 1980-1984, the average annual growth rate of M1 in the United States was about twice as high as in Japan and in West Germany, but the dollar rose against the DMark sharply and remained, on balance, little changed versus the yen. Also, no correlation with the currency behavior can be found when comparing actual versus targeted money growth between countries. For example, in the United States, in three out of these five years, the M1 target was exceeded. In West Germany, on the other hand, in three years actual growth of central bank money fell within the target, and in two years it was even below. But this did not prevent the dollar from appreciating against the DMark.

- The spectacular rise of the dollar cannot be attributed to the widening budget deficit or interest rate movements. It

happened not because monetary policy had become monetarist-oriented, nor because it deviated from monetarism. The dollar appreciation can be traced to three main factors: (a) the sharp drop in U.S. inflation; (b) the strength, dynamism and flexibility of the American economy, contrasting with a generally sluggish performance and rigidities of the economies of most other industrial nations and financial crises in many developing countries; (c) political considerations, projecting the United States as a politically stable country and a relatively safe place for international investors. The combination of these factors led to a strong inflow of foreign capital to the United States as well as to a drastic cut of capital outflow from America, creating a scarcity of dollars in international credit markets.

The dollar and the trade deficit

- The most questionable element of the conventional reasoning is the almost axiomatic contention that the rise in the dollar's value has been responsible for our trade and current-account deficits. This general belief is mainly due to the fact that the increase in the trade deficit - from $25 billion in 1980 to $108 billion in 1984 - coincided with the appreciation of the dollar. However, analysis of the geographical structure of the U.S. trade deficit in 1983 and 1984, the two years when the deficit really soared, strongly denies the validity of this perception.

The analysis shows that Japan was the biggest contributor to the two-year shortfall of roughly $170 billion; its share amounted to $53 billion, i.e. 31% of the total. But the dollar's exchange rate against the yen did not change much (see Annex 2): during these two years, the dollar was up only 7%, and in the 5 1/2 year period between the end of 1979 and the middle of 1985, only by 3.8%. Even those economists who most consistently attribute our trade deficit to the dollar's appreciation, admit that this hardly applies to Japan. It is the difficult access for our goods to the Japanese market, low domestic consumption there, superior quality of Japanese products and their low production costs that are mainly responsible for Japan's trade surpluses with the United States and, for that matter, with most other countries. In fact, the U.S. had permanent trade deficits with Japan for the past 20 years, regardless of what was happening to the dollar/yen exchange rate during that time span.

About 20% of the U.S. trade deficit in the 1983-1984 period was with Canada. But the Canadian dollar has been kept largely in line with the U.S. dollar. In these two years, it fell by just 7.3% vis-a-vis the U.S. currency. About 22.5% of our trade deficit can be attributed to countries whose currencies are by and large pegged to the dollar (e.g., Taiwan, Hong Kong, South Korea, Indonesia, Singapore). A fall in the dollar's value would have little impact on imports from these countries since their currencies would move in unison with the dollar. Finally, 12.5% of the trade deficit was

versus Mexico and Brazil, but this was not because of the dollar's appreciation; rather, it was due to the restrained U.S. exports to these countries and their strong export expansion, both events clearly related to their precarious payment situation.

Thus, over 85% of the U.S. trade deficit in the last two years was with countries where there was very little or no appreciation of the dollar, or where the appreciation did not play any role in trade flows.

- It was not the strong dollar that really caused the trade deficit. Other factors played a more significant role. First, the collapse of U.S. exports to Latin America, because of the debt crisis there, has been a major contributor to our trade deficit, particularly in 1982 and 1983 when this factor was responsible for nearly 50% of the trade balance deterioration. Even in 1984, when these exports recovered somewhat, they were still one-third lower than in 1981.

Second, the disparity of economic growth between the U.S. and other industrial nations played a predominant role in 1983 and 1984. During that period, the U.S. economy grew by 10.8% in real terms, compared with 3.8% in Western Europe and 9.3% in Japan. This disparity affected primarily the import side of the trade balance; in 1984 alone, the volume of U.S. imports surged by 26%. According to a recent study by the Bank for International Settlements in Basle,

Switzerland, 55% of last year's increase in U.S. import volume can be attributed to the strength of domestic demand, while the remaining 45% to all other factors, including the rise of the dollar.

Finally, many other reasons, unrelated to the exchange rate or predating the dollar's rise, have been prevalent. One can mention here, for example, progressing plant obsolescence in several U.S. industries, high relative labor costs, increasing world grain output that reduced demand for U.S. grain, greatly improved quality of many foreign products, mounting trade barriers abroad, etc. A widening trade deficit due to these reasons was inevitable even if the dollar had not risen.

- If it were the dollar's exchange rate that was primarily responsible for our mounting trade deficit, it would have to be associated with a drop in import prices. But this was not the case. In fact, between 1980 and 1984 non-oil import prices rose by 3.2%. In 1984 alone, when the dollar appreciated by 15%, they went up by 2.7%. True, this was somewhat less than the increase in domestic prices, so that the relative price of imports gave foreign products some competitive edge. But the price differential was much too small to explain the huge jump in import volume that occurred last year. Obviously, the import pull of the American economy was so strong that foreign exporters did not need to reduce their prices in order to sell in the American market. When the dollar falls, they can be expected to initially reduce their profit margins rather than to raise prices, in order to keep their market shares. Consequently, the trade deficit is not likely to be affected much.

Assessment of the G-5 agreement.

- The G-5 agreement of September 22, 1985 to weaken the dollar through intervention in foreign exchange markets is, in my view, by far the most important change in the Reagan Administration's economic policy. The importance of this change is not so much that after five years of a "hands-off" attitude the Administration has accepted intervention in currency markets as an instrument of international monetary policy, but rather that it has decided to weaken the dollar. In fact, the mere announcement of the agreement had a more powerful impact than the intervention itself; it changed the market psychology vis-a-vis the dollar.

- To be sure, attempts to weaken the dollar by publicly deploring its strength have been going on throughout the whole period of the rising dollar trend as it was widely perceived that the strong dollar was hurting the U.S. economy. These efforts to "talk the dollar down," resembling the first two years of the Carter Administration, had no discernible impact as long as they were practiced by public officials responsible for particular sectors of the economy, such as the Secretaries of Commerce and Agriculture or the U.S. Trade Representative. These attempts turned out to be much more successful when pursued by more influential policymakers. For example, when the Chairman of the Federal Reserve, earlier this year, had expressed his irritation that the strength of the dollar limits

his ability to run monetary policy according to domestic considerations alone, the dollar dropped sharply. Its value was further reduced when the Secretary of the Treasury had publicly stated that he was not displeased with this dollar decline. Indeed, between its peak in late February and the time immediately preceding the G-5 agreement, the dollar fell by 15% (Annex 3), mainly due to the deteriorating psychological climate surrounding the currency. With the G-5 agreement, what previously were incidental attempts to "talk the dollar down," has now become offical policy of the U.S. Administration. Since the G-5 agreement, the dollar has dropped by another 7.5%.

- I am stressing the significance of psychological factors in affecting the value of the dollar. It is not so much intervention as the threat of intervention that moves the markets. In fact, intervention alone is not likely to have a lasting effect, especially if its impact on domestic money supply is neutralized ("sterilized".) To have a more sustained effect, it must be followed by more fundamental changes in economic policy.

Reportedly, the G-5 agreement provided for such changes, particularly on the part of the Japanese and the Europeans. They were supposed to stimulate their domestic demand by more expansionary fiscal and monetary policies. No doubt, they can well afford to do this: they have brought inflation under control, they are running

large balance-of-payments surpluses and their fiscal deficits are sharply reduced. Yet, while Japan has revealed a package of measures aimed at increasing economic growth, the program is rather timid and cannot be considered a major policy change. More importantly, the Western European nations have flatly denied that they intend to make any changes in their economic policies.

- Changes in economic policies are the key to bringing about more balanced conditions in international economic relations. But they pose serious political problems. Theoretically, a country that wants to weaken its currency has to inflate its economy, and vice versa - a contractionary, deflationary course would be necessary for a country that strives at currency appreciation. However, this is not exactly what the five partners to the Plaza Hotel agreement had in mind. Hardly anyone would advocate putting the U.S. economy back on an inflationary track, although this is inevitable if the dollar indeed were to depreciate significantly. Even more contradictory is the agreement from the other side's point of view. The Europeans and the Japanese would be required to deflate their economies. But this would be sheer nonsense, considering that their economies are sluggish, unemployment at very high levels and inflation disappearing.

- As indicated earlier in this paper, it is an illusion to expect that a lower dollar would eliminate the U.S. trade deficit. It could make some dent, but the reduction would be relatively small. On

the other hand, a significant decline in the dollar's value, while helping our export and import-competing industries, would have important negative effects on the economy as a whole.

There are four major negative consequences of the dollar's depreciation.

1. A negative shift in the terms of trade.

The macro-economic importance of this development, greatly neglected if not totally ignored in our economic debates, cannot be overestimated. A deterioration of the terms of trade, which is an inevitable consequence of a currency devaluation, is comparable to a loss in productivity. It makes the nation poorer as it leads to spending a greater volume of the nation's output for acquiring a unit of imports. Countries, nevertheless, resort to currency devaluations from time to time, hoping that the negative shift in the terms of trade would quickly result in an improved trade balance by raising the volume of exports and limiting that of imports. This may be an appropriate policy for countries trading in highly competitive markets, and whose exports and imports are highly price sensitive. But it does not make much sense for the United States, whose export structure is characterized by relatively low price elasticity. Lower export prices would only to a limited extent lead to higher export volumes since price is not the most important determinant of foreign

demand for much of U.S. exports. Other considerations, like technological superiority and other non-price qualities, play a more important role. On the other hand, very high income elasticity of our imports would limit the exent of restraining import volumes even at higher prices.

2. Increasing difficulties in financing the balance-of-payments deficits.

Once confidence in the dollar in the currency markets gets undermined, the country would face increasing problems in financing the current-account deficit and, indirectly, the Federal budget deficit. To be sure, there is no danger that the current-account deficit won't be fully financed - in fact, it can be incurred only to the extent it can be financed. A deficit on the current account must have by definition its equivalent in a net capital surplus. Furthermore, the United States is in a better position in this respect than other countries because of the unique international function of the dollar as the main reserve currency. This function gives the United States an additional source of foreign capital, unavailable to other nations.

Nevertheless, inflow of private capital could be impaired if the dollar drops. Foreign investors, facing a risk of further

depreciation, may demand a higher rate of interest to cover this risk. Of course, the foreign exchange risk premium could be partially neutralized if interest rates in the investor's country go down, but this seems unlikely in the present situation. (In fact, interest rates have recently gone up in Japan and West Germany.) The consequence, therefore, would be an upward pressure on U.S. domestic rates. In short, a fall in the dollar's value should not affect the availability of domestic credit, but rather impair total credit flow available to domestic borrowers, thus requiring higher interest rates.

Inhibited foreign funding of domestic needs will particularly affect the corporate sector. It will manifest itself first in the Eurobond market, which has shown a rapid development since August 1984 when the change in U.S. tax regulations permitted U.S. corporations direct access to that market. Experience shows that the Eurobond market is particularly sensitive to exchange rate changes. Bond issuance tends to drop parallel to the drop in the dollar's value. As a result, this unsatisfied credit demand will shift to the domestic bond market and to the banking system, putting upward pressure on interest rates, loan growth and the money supply.

It should be also noted that in an extreme case of a free fall of the dollar, net inflow of private capital might stop altogether and

turn into net outflow. This was the case in 1977 and 1978 during a pervasive dollar weakness, largely engineered by the Carter Administration to correct the current-account deficit. At that time, it was inflow of official capital, representing foreign central banks' intervention in the exchange markets to support the dollar, that was the equilibrating force. I don't expect, though, something similar to happen now, since the Federal Reserve will most probably strive to prevent such a development.

3. Rising inflation.

The most important benefit of the dollar's appreciation has been its contribution to curbing U.S. inflation. This has been achieved not only by direct restraint on import prices, but also through a dampening influence on prices of domestically produced goods competing with imports. Moreover, the rise in the dollar's exchange rate has had a strong effect on the overall improvement in productivity and efficiency of U.S. industries confronted with increased foreign competition. It has forced both our export and import-competing industries to cut costs to a larger extent than justified by cyclical conditions alone. In addition, the dollar's rise has had a beneficial effect on curbing inflation worldwide as exporters of products traded in dollars (most commodities, including oil) tended to reduce their prices not only because of weak demand conditions, but also because they were exchanging their goods for an appreciating currency.

This process is now bound to reverse itself. Admittedly, the inflationary response to the dollar's decline will be relatively slow because - as mentioned before - foreign exporters will tend first to squeeze their profit margins rather than raise prices, in order to preserve market shares. But the inflationary impact of a falling dollar is inevitable. It will show up first in commodity prices, and indeed some of them have already begun to rise. The G-5 agreement, if implemented aggressively, will be viewed, in retrospect, as the beginning of a new inflation trend in the United States. Apparently, the U.S. disinflation of the past several years has turned out to be too painful for many sectors of the economy.

4. Upward trend in interest rates.

Interest rates, both short and long, are likely to rise in order to attract inflow of foreign capital (Item 2) and due to higher inflation (Item 3), and this is likely to happen even if monetary policy remains neutral. Chances are, however, that monetary policy will not remain neutral. If the dollar shows a tendency of dropping sharply, the Fed most probably will tighten moentary policy in order to prevent its further fall and the resulting inflationary consequences. This would create an additional force towards pushing interest rates up.

The extent of the rise in interest rates and its timing are impossible to predict. They would depend on the tempo and degree of the dollar's depreciation, on the response of foreign investors, on the inflationary impact of the lower dollar and the Federal Reserve's position.

Conclusions

- While the dollar has dropped by over 20% since its February high and by 15% since its end-1984 level, the currency remains fundamentally strong. All the main forces that have been supporting it during the long rising trend remain largely in place. Even though U.S. economic growth has slowed down this year, the United States is still an attractive investment outlet when compared with other nations. Foreigners still view the United States as a more rewarding and safer place for investing their money.

- A strong currency is a mixed blessing for any country; it has its positives and negatives and it is the task of the policymakers to evaluate the net impact of the conflicting forces. In my view, the strong dollar, while hurting our export and import-competing industries, has been, on balance, good for the United States in the macro-economic sense. It has been also beneficial for the world economy, even though foreigners have been complaining persistently that the dollar is too strong. Needless to say, they had also complained several years ago when the dollar was weak.

- Despite its underlying strength, the dollar can be easily knocked down if the market participants become convinced that the American Government is indeed determined to weaken its own currency. They will position themselves accordingly, and the decline may assume snowballing symptoms. The risk of such a policy is that it deals with market psychology which cannot be quantified. If confidence in the dollar is undermined, the currency could move into an uncontrollable plunge.

- The G-5 agreement to weaken the dollar is a mistake. It cannot achieve its presumed goal of eliminating, or even significantly reducing, the trade deficit. It will have instead serious negative effects on the economy by worsening the terms of trade, impairing net capital inflow, reigniting inflation and raising interest rates.

- The key to solving the trade deficit problem lies in faster economic growth in other industrial nations. They would then import more from the United States. Moreover, they would also increase imports from the developing countries, thus contributing to easing the LDCs' debt crisis, which could eventually lead to a resumption of our exports to this important area. However, the other industrial nations are unwilling, or unable, to change their economic policies. Consequently, large trade deficits are likely to persist in the foreseeable future, and there is very little we can do about it. But this would mean that our trading partners would have to keep financing these deficits, directly or indirectly, through net capital inflow to the United States. And to facilitate this inflow we need a strong dollar.

- Contrary to its apparent desire, the Federal Reserve will have more problems in pursuing monetary policy with a weak dollar than it had with a strong dollar. But it is only the Fed that might be able to control the damage resulting from a falling currency.

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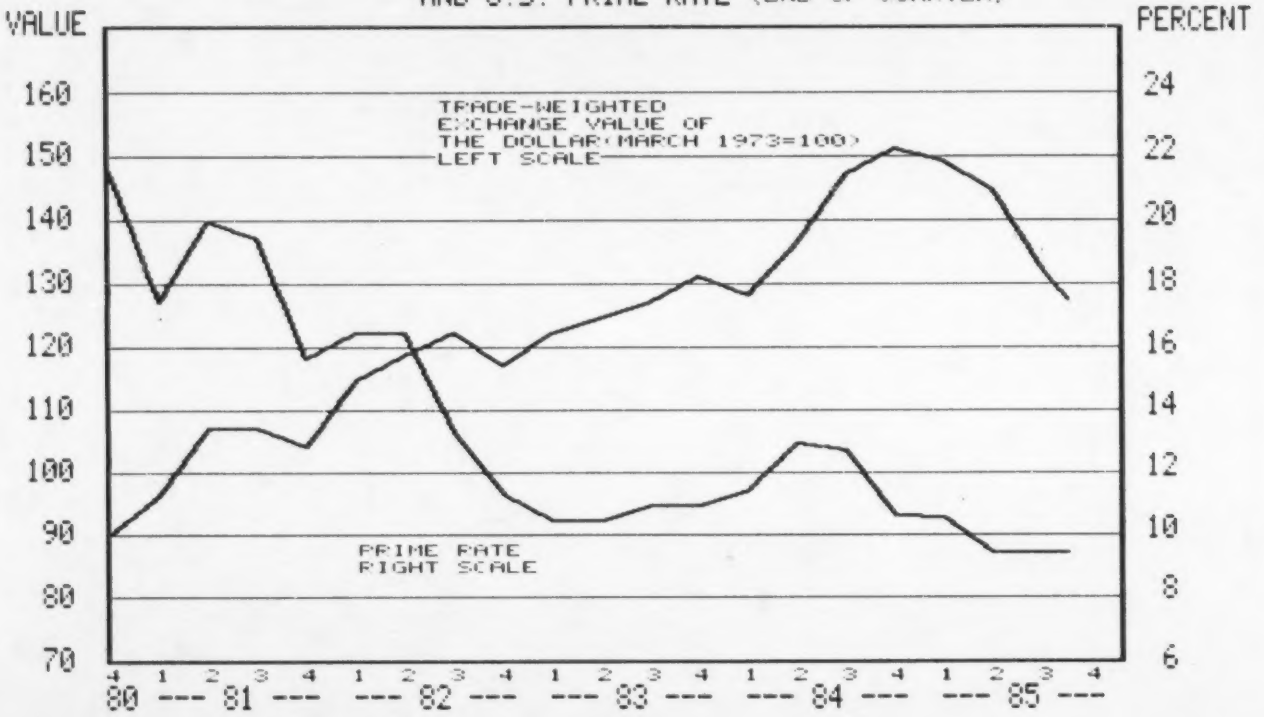
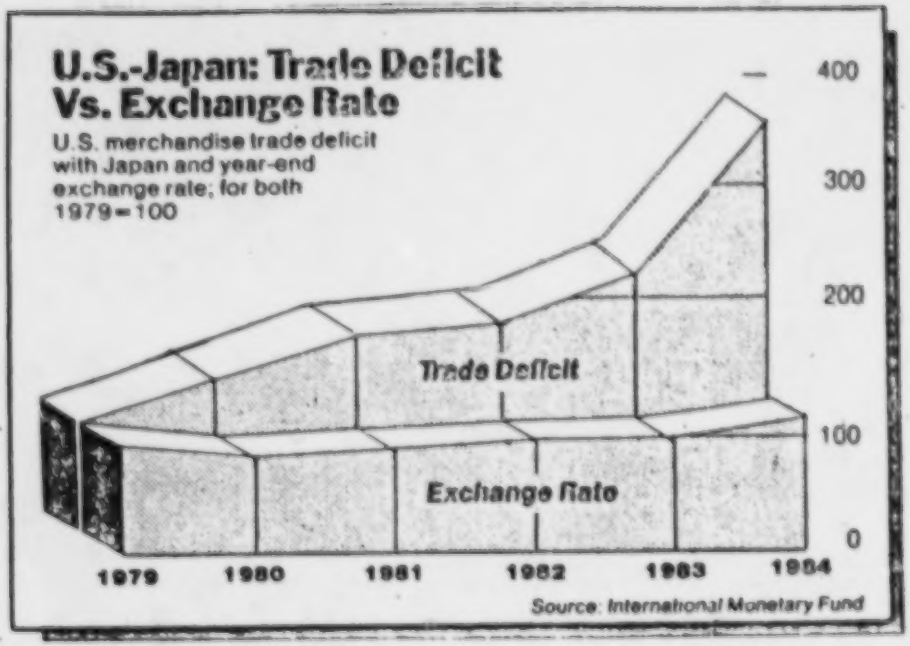
TRADE-WEIGHTED EXCHANGE VALUE OF THE DOLLAR AND U.S. PRIME RATE (END OF QUARTER)



Source: FEDERAL RESERVE BOARD


U.S.-Japan: Trade Deficit
Vs. Exchange Rate
U.S. merchandise trade deficit with Japan and year-end exchange rate; for both 1979=100
400
300
200
100
0
Trade Deficit
Exchange Rate
1979
1980
1981
1982
1983
1984
Source: International Monetary Fund

ANNEX 3

TRADE-WEIGHTED DOLLAR EXCHANGE VALUE

		%	%	%
July 10, 1980	84.12(Low)			
December 31, 1980	90.39			
December 31, 1981	104.69	+95.8		
December 31, 1982	117.36			
December 30, 1983	131.74			
December 31, 1984	151.47			+53.5
February 25, 1985	164.72 (High)	-15.5		
September 20, 1985	139.25	-7.3	-21.6	
October 31, 1985	129.11			

Source: Federal Reserve Board (March 1973=100)

Chairman FAUNTROY. Thank you so much, Dr. Karczmar, for your provocative and stimulating testimony.

We move on now to Mr. Rempell, from Merrill Lynch.

STATEMENT OF KENNETH REMPELL, MERRILL LYNCH PIERCE FENNER & SMITH

Mr. REMPELL. Fortunately, Mr. Chairman, not being an economist and market person, I have learned to do things quickly, and I will try to do that here as well.

Today the United States is entering a new era—we are no longer a net creditor nation. The United States became a net debtor for the first time since World War I in the first half of 1985. In fact, the United States was the world's largest creditor in 1982, but by the end of 1986, it will be the world's largest debtor. By 1990, many analysts estimate the net external debt may approach $1 trillion.

Against this background, I shall focus on the impact a falling dollar may have on interest rates. The recent G–5 accord, to lower the value of the U.S. dollar relative to the Japanese yen in particular, as well as other currencies, has led to several policy decisions. Initially we saw direct intervention by the central banks and the foreign exchange markets.

More recently the Bank of Japan failed to relieve a seasonal liquidity shortage in the Japanese money market. The ensuing li-

quidity squeeze forced money market participants to scramble for scarce funds, pushing short-term interest rates up 125 basis points. The Japanese bond market sold off as well. In the 10-year sector, prices fell about seven points in 2 days. Yields rose 1¼ percent. Earlier this year, when sterling was under extreme pressure, the Bank of England had to raise short-term rates by more than 4 percent before the market became willing to hold sterling. These events remind me of the chickens come home to roost with vengence scenario we heard about earlier.

I believe the most recent decline of the dollar was inspired by the agreement to intervene, but not caused by the accord. Of course, the unified declaration of intent by the G–5 had a tremendous psychological impact. But the record clearly demonstrates the impact of intervention is short term. From 1977 to 1979, the United States intervened heavily to halt the dollar's slide, but this failed because steps to correct the underlying problems were slow to emerge. Not until October 1979, when the Federal Reserve shifted its operating procedures to allow greater flexibility in U.S. interest rate and monetary management, did the outlook for the dollar fundamentally change.

Following the Versailles economic summit meeting in 1982, a study on the effectiveness of intervention was commissioned. In April 1983, the study was completed and its findings were released. The Working Group Report on Exchange Market Intervention concluded that intervention is likely to have at best a small temporary impact on exchange rates to counter: one, disorderly market conditions; two, unanticipated political, economic, and financial shocks; and, three, bandwagon psychology. To the extent that this has an impact on exchange rates, the effectiveness of intervention probably stems more from the announcement effect and less from the actual intervention per se. Efforts to resist fundamental long-term currency trends by leaning against the wind are unlikely to be successful.

We did see a great deal of intervention this past year, in 1984, and the dollar continued to go up.

As I stated previously, the G–5 accord inspired, but did not cause, the most recent decline. The dollar was falling anyway. In September 1984, the DM/dollar exchange rate traded through the 3 DM/dollar level. By February 1985, the dollar traded as high as 3.56 DM. Prior to the most recent announcement by the G–5, the dollar was trading slightly over 2.90 DM. The point is clear: the dollar was weakening prior to the accord, not because of the accord.

Although the subcommittee is particularly interested in the impact a falling dollar may have on interest rates, I believe the greater issue at hand is whether U.S. flexibility in managing an interest rate policy will be constrained by the increased foreign exchange component.

Over time, the relative value of a currency certainly impacts upon prices and economic activity. The weak manufacturing sector, the less competitive farm sector, and the modest inflation indices of the last 2 years, I view this as evidence the strong dollar does impact on these areas. I do believe a weakening dollar will reverse these trends.

As the dollar declines and the effect of such a decline works through the economy, we will be confronted with an environment unlike any we have witnessed in the United States.

First, as I mentioned at the outset, the United States has gone from the world's largest creditor to a significant debtor position. By 1990, the cost of servicing a $1 trillion net external debt could amount to $100 billion annually. If future current accounts after 1990 were to be brought into balance, the United States would have to run trade surpluscs amounting to about $100 billion annually just to offset the interest payment outflow.

Second, the globalization of the world bond markets will encourage and facilitate cross border capital movements. Evidence of the globalization process is clear and present. The following story from Tokyo appeared on Reuters on October 28, following the recent action by the Bank of Japan:

> The abrupt rise in Yen interest rates from Bank of Japan action to firm the yen is expected to depress recent strong Japanese demand for high yield U.S. securities, bond and foreign exchange dealers said.
>
> This is because Japanese investors are becoming more attracted to the high yen interest rates developing in Japan since last week's deep fall in bond market prices. They are also less willing to take on foreign exchange risks linked with overseas investment for fear of further dollar weakness.
>
> "I thought Japanese buying of foreign bonds would be sparked by a dollar fall below 210 yen. But now I cannot say that is likely", said Mayayushi Shirota, general manager of Nomura Government Securities Co. Ltd.'s foreign bond trading.

Initially, all bond markets reacted to the decline in Japan. Longer dated U.S. Treasuries opened one-half point lower than the previous close. This was the first time that I can recall the U.S. bond market reacting to events in a foreign bond market.

Non-U.S. based investors have been watching dollar bonds for quite some time. The Eurobond market has provided a vehicle for foreigners to invest in dollar securities for a number of years. More recently, dealers in U.S. Treasuries have established operations in London and Tokyo to market dollar debt to nondollar-based investors. The London International Financial Futures Exchange [LIFFE] included contracts on U.S. Treasury bonds and Eurodollar deposits. In Singapore, the Simex included a contract on Eurodollar certificates of deposit.

The general belief is that foreigners have no real alternative to the U.S. market which offer both size and liquidity. It is usually stated that OPEC in the 1970's and, most recently, Japanese investors needed the U.S. market to store their reserves. Today I would suggest the markets are changing—not only for the nondollar-based investor, but for the dollar-based investor as well.

The financial futures markets may provide a clue as to what may be in store. As I stated, dollar products are offered in London and Singapore. Now, many believe nondollar financial futures will be traded in the United States. Trading recently began in the yen bond futures. The contract may now be duplicated by the Chicago Board of Trade [CBT] and the LIFFE in London. How long will it be until we add contracts on Canadians, gilts, Australian, and other nondollar bonds?

One of the real constraints on nondollar debt investing has been the size of the foreign markets relative to the United States. Here, too, I detect a change which will further the process of globaliza-

tion. In 1984, offshore issuance in the Deutschemark, yen, ECU, and French markets totaled almost $16 billion. For the first 9 months of 1985, total issuance has grown to over $20 billion. During the month of October, we witnessed a substantial increase in nondollar issuance. Euro-Deutschemark financing was over $1.2 billion and the queue for November is already $2.75 billion. As the nondollar market expands so, too, will its liquidity. A larger market with greater liquidity will become increasingly attractive to dollar-based, as well as non-dollar-based investors.

This brings me back to a concern I raised earlier. Will interest rates in the United States be more and more influenced by foreign exchange considerations? In 1985, we have seen Japan and the United Kingdom push up their rates to support their currencies. I might add, in the last few days, we have seen Australia do likewise. We have seen time and time again the short-term influence of intervention. Intervention is not a very reliable tool. We are witnessing the United States becoming the world's largest debtor, becoming more and more dependent on foreign capital. We are witnessing the globalization of the world's bond markets. This process may not only make it more difficult to retain foreign capital, but will facilitate the movement of U.S. capital offshore.

American consumers and purchasing agents have become very comfortable buying imported goods when economically it is the sensible course of action, as long as the infrastructure exists to support this activity. As the infrastructure for domestic investors develops, will they become more global in their outlook? I believe it is inevitable. Thank you.

[The prepared statement of Mr. Rempell follows:]

Statement by

Kenneth Rempell
Merrill Lynch Pierce Fenner & Smith

Today the United States is entering a new era - we are no longer a net creditor nation. The U.S. became a net debtor for the first time since World War I in the first half of 1985. In fact, the United States was the world's largest creditor in 1982, but by the end of 1986, it will be the world's largest debtor. By 1990, many analysts estimate the net external debt may approach $1 trillion.

Against this background I shall focus on the impact a falling dollar may have on interest rates. The recent G-5 accord, to lower the value of the U.S. dollar relative to the Japanese yen in particular as well as other currencies, has led to several policy decisions. Initially we saw direct intervention by the central banks in the foreign exchange markets. More recently, the Bank of Japan failed to relieve a seasonal liquidity shortage in the Japanese money market. The ensuing liquidity squeeze forced money market participants to scramble for scarce funds, pushing short-term interest rates up 125 basis points. The Japanese bond market sold off as well. In the ten year sector, prices fell about seven points in two days. Yields rose one and a quarter percent. Earlier this year, when sterling was under extreme pressure, the Bank of England had to raise short-term rates by more than four percent before the market became willing to hold sterling.

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As I stated previously, the G-5 accord inspired, but did not cause, the most recent decline. The dollar was falling anyway. In September 1984 the DM/Dollar exchange rate traded through the 3.00 DM/Dollar level. By February 1985 the dollar traded as high as 3.46 DM. Prior to the most recent announcement by the G-5, the dollar was trading slightly over 2.90 DM. The point is clear: the dollar was weakening prior to the accord not because of the accord.

Although the subcommittee is particularly interested in the impact a falling dollar may have on interest rates, I believe the greater issue at hand is whether U.S. flexibility in managing an interest rate policy will be constrained by the increased foreign exchange component.

Over time, the relative value of a currency certainly impacts upon prices and economic activity. The weak manufacturing sector, the less competitive farm sector (it was actually economically viable to import wheat), and the modest inflation indices of the last two years attest to the implications of a strong dollar policy. I believe a weakening dollar will reverse these trends.

As the dollar declines and the effect of such a decline works through the economy, we will be confronted with an environment unlike any we have witnessed in the United States.

First, as I mentioned at the outset, the United States has gone from the world's largest creditor to a significant debtor position. By 1990, the cost of servicing a $1 trillion net external debt could amount to $100 billion annually. If future current accounts after 1990 were to be brought into balance, the U.S. would have to run trade surpluses amounting to about $100 billion annually just to offset the interest payment outflow.

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Non-U.S. based investors have been watching dollar bonds for quite some time. The Eurobond market has provided a vehicle for foreigners to invest in dollar securities for a number of years. More recently, dealers in U.S. Treasuries have established operations in London and Tokyo to market dollar debt to non-dollar based investors. The London International Financial Futures Exchange (LIFFE) included contracts on U.S. Treasury bonds and Eurodollar deposits. In Singapore, the Simex included a contract on Eurodollar certificates of deposit.

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One of the real constraints on non-dollar debt investing has been size of the foreign markets relative to the United States. Here, too, I detect a change which will further the process of globalization. In 1984, offshore issuance in the Deutschemark, Yen, ECU, and French markets totalled almost $16 billion. For the first nine months of 1985 total issuance has grown to over $20 billion. During the month of October we witnessed a substantial increase in non-dollar issuance. Euro-Deutschemark financing was over $1.2 billion and the queue for November is already $2.75 billion. As the non-dollar market expands so, too, will its liquidity. A larger market with greater liquidity will become increasingly attractive to dollar based, as well as non-dollar based, investors.

This brings me back to a concern I raised earlier. Will interest rates in the United States be more and more influenced by foreign exchange considerations? In 1985 we have seen Japan and the U.K. push up their rates to support their currencies. We have seen time and time again the short-term influence of intervention. Intervention is not a very reliable tool. We are witnessing the United States becoming the world's largest debtor, becoming more and more dependent on foreign capital. We are witnessing the globalization of the world's bond markets. This process may not only make it more difficult to retain foreign capital, but will facilitate the movement of U.S. capital offshore.

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Chairman FAUNTROY. Thank you for such a rosy picture. Dr. Kilcollin, would you kindly present your testimony. We have it in writing. You may summarize as you will.

STATEMENT OF THOMAS ERIC KILCOLLIN, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, ON BEHALF OF THE CHICAGO MERCANTILE EXCHANGE

Mr. KILCOLLIN. Thank you, Mr. Chairman.

I am here representing the views of the Chicago Mercantile Exchange. The Chicago Mercantile Exchange, organized in 1919, is the leading international exchange trading futures and options contracts on a wide variety of products including currencies, interest rates and stock indexes as well as basic commodities such as livestock and lumber.

Where prices are free to vary, the Exchange provides both a private sector means of determining and disseminating that price as well as a mechanism for transferring price risk. Given our long experience in observing the operation of the price mechanism in a wide variety of markets, including the foreign exchange markets, I would like to focus my comments primarily on the last question this committee indicated it wanted to raise, but a question I believe is very important; namely, the question of the desirability of fixed versus flexible exchange rates.

Under our current flexible rate regime, two issues have arisen, and I believe they are two separate issues. One is the contention the dollar is too high, and second a contention the dollar is too variable. By inference, there is an implication under a fixed rate regime we could avoid both of these so-called problems.

First to address the strength of the dollar, my comments here parallel those of others, so I will try to keep them brief. I believe that the notion the dollar is too high really arises from the observation that currently we import more than we export on the trade account. The high dollar is somehow seen as causing this imbalance. Nothing could be further from the truth: a price does not cause a fundamental in the market, rather price is a result of a fundamental in the market.

In this case, the appearance of price causing a trade imbalance results from a failure to consider capital flows reflecting the fiscal positions of the United States and the rest of the world. The recent extraordinary Federal budget deficits can only be funded through restricting investment, increasing savings or exporting our debt. Obviously we do not want to restrict investment, and we have been unable to generate sufficient savings to fund both investment and the deficit. Therefore, we have had to resort increasingly to exporting our debt.

At the same time, other countries have followed policies that tend to encourage their acceptance of our debt. As a simple matter of accounting, large exports of debt can only occur to the extent that exports of goods and services are curtailed or imports of goods and services are increased. Thus, rather than the strong dollar causing the trade deficit, it would be more accurate to state that the strong dollar is the equilibrating factor enabling trade exports

and imports to make the adjustments required to accommodate our large export of debt.

Another very important point in this respect is that, given the need for foreign capital and the inevitable trade deficit it entails, permitting the price mechanism of freely floating exchange rates to determine how that trade deficit is to be achieved is perhaps the most equitable and certainly the most efficient means of getting an admittedly dirty job done.

In the absence of this price mechanism, who could determine what imports provide the greatest value to Americans and, therefore, should be increased? In the absence of this price mechanism, who could determine what exports are least competitive in the world marketplace and, therefore, should be sacrificed first? I dare say that no individual or group of individuals would profess themselves equal to these tasks. Yet the price system has demonstrated its ability over and over again to produce just these results, I might add, without the expenditure of a single Federal dollar.

In making these points, I do not mean to suggest that the dollar may not be misaligned in some fundamental sense or that the economic costs associated with any such misalignment are not substantial. My point is that any such misalignment is the result of misaligned macroeconomic policies, not of flexible exchange rates. Flexible exchange rates themselves act to minimize the economic cost of these policies.

The variability of the dollar: Variability in foreign exchange rates produces business risk, and while business risk produces opportunity to gain as well as loss, it is probably true that, on average, business prefers less risk to more. Hence, the notion that Government should fix foreign exchange rates to eliminate this source of business risk.

I could make essentially the same argument for the Government acting to fix prices in the stock market, perhaps buying or selling stock to peg the level of the Dow Jones Average. Such an argument would, no doubt, be considered absurd. It is no less absurd for currency prices than it is for stock prices.

The case against fixing foreign exchange rates to eliminate business risk is compelling. First there is essentially no evidence that foreign exchange rates are subject to destabilizing speculation of the sort that might suggest a role for government to counteract. Indeed, there is ample evidence to suggest the opposite, namely, that it is Government intervention that is usually destabilizing. Instead, as with other prices, foreign exchange rates appear to respond to changing fundamentals in the market. Why should the international trade sector of the economy be shielded from fundamental changes when the rest of us have to live with this uncertainty?

Second, there already exist market mechanisms for business to deal with foreign exchange risk. As this committee is no doubt aware, interbank and exchange markets transfer foreign exchange risk daily on large sums of currency. Indeed, the Chicago Mercantile Exchange has recently established a link with the Singapore International Monetary Exchange to enable this risk to be transferred efficiently even in the middle of the night when U.S. markets are closed.

Given the existence of these market mechanisms for handling risk, foreign exchange risk is surely among the easiest business risks to deal with. Indeed, the record shows that U.S. foreign trade as a ratio to gross national product has more than doubled since the demise of fixed exchange rates in 1971. It is difficult to argue from these data that business cannot cope with variable exchange rates.

Third, it would be very expensive to fix foreign exchange rates. As an economist, I would be remiss in not mentioning first what is perhaps the major cost, a cost that is hidden and hard to quantify, of any price-fixing scheme: The misallocation of resources it produces. It goes without saying that the direct cost to the taxpayer would be large, as it generally is with Government price-fixing schemes. But the aspect of currency price fixing that is truly frightening is that in order for it to succeed, theory and evidence both suggest that domestic monetary policy would have to be dedicated to this end and coordinated with our trading partners.

While I certainly would not want to argue that we have always used wisely the freedom that flexible exchange rates have afforded us in the domestic policy area, to paraphrase William Jennings Bryan, I would much prefer the pitfalls of this freedom to being crucified on a latter-day cross of gold. A fixed exchange rate would not rid us of risk, it would merely shift that risk to other economic variables, such as inflation, deflation or changes in output, where the risk may be harder to quantify and where the market mechanisms do not exist to handle risk.

The fixed-exchange rate regime broke down in the early 1970's because we and others found these costs unbearable. With the greater divergence of economic policies and important economic entities in the world today, surely it is unthinkable that fixed exchange rates could be workable now.

In summary, the level and variability of the dollar are not problems in their own right. They are in part messengers bringing us news that all is not quiet on the economic front and, in part, they are mechanisms for the efficient dealing with that news. If we don't like the news, we should deal with the underlying problems. We should resist trying to deal with the news by shooting the messenger.

Thank you.

[The prepared statement of Dr. Kilcollin follows:]

Testimony

of

Thomas Eric Kilcollin

Senior Vice President and Chief Economist
Chicago Mercantile Exchange

before

U.S. House of Representatives

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

November 7, 1985

Introduction

My name is Rick Kilcollin, Senior Vice President and Chief Economist of the Chicago Mercantile Exchange. The Chicago Mercantile Exchange, organized in 1919, is the leading international exchange trading futures and options contracts on a wide variety of products including currencies, interest rates and stock indexes as well as basic commodities such as livestock and lumber. Where prices are free to vary, the Exchange provides both a private sector means of determining and disseminating that price as well as a mechanism for transferring price risk. Given our long experience in observing the operation of the price mechanism in a wide variety of markets, including the foreign exchange markets, I would like to focus my comments primarily on the question of the desirability of fixed vs. flexible exchange rates.

The current debate on this issue seems to involve two different issues: a contention that the dollar is too high and a contention that the dollar is too variable.

The Strength of the Dollar

No doubt, the notion that the dollar is too high arises from the observation that we currently import more than we export on the trade account. The high dollar is somehow seen as "causing" this imbalance. Nothing could be further from the truth: a price does not cause a fundamental in the market, rather price is a result of a fundamental in the market. In this case, the appearance of price causing a trade imbalance results from a failure to consider capital flows reflecting the fiscal positions of the United States and the rest of the world. The recent extraordinary federal budget deficits can only be funded through restricting investment, increasing savings or exporting our debt. Obviously, we do not want to restrict investment; and we have been unable to generate sufficient savings to fund both investment and the deficit. Therefore, we have had to resort increasingly to exporting our debt. At the same time other countries have followed policies that tend to encourage their acceptance of our debt. As a simple matter of accounting, large exports of debt can only occur to the extent that exports of goods and services are curtailed or imports of goods and services are increased. Thus, rather than the strong dollar causing the trade deficit, it would be more accurate to state that the strong

dollar is the equilibrating factor enabling trade exports and imports to make the adjustments required to accommodate our large export of debt.

Another very important point in this respect is that, given the need for foreign capital and the inevitable trade deficit it entails, permitting the price mechanism of freely floating exchange rates to determine how that trade deficit is to be achieved is perhaps the most equitable, and certainly the most efficient, means of getting an admittedly dirty job done. In the absence of this price mechanism, who could determine what imports provide the greatest value to Americans and therefore should be increased? In the absence of this price mechanism, who could determine what exports are least competitive in the world marketplace and therefore should be sacrificed first? I daresay that no individual or group of individuals would profess themselves equal to these tasks. Yet the price system has demonstrated its ability over and over again to produce just these results - I might add without the expenditure of a single federal dollar.

In making these points, I do not mean to suggest that the dollar may not be misaligned in some fundamental sense or that the economic costs associated with any such misalignment are not substantial. My point is that any such misalignment is the result of misaligned macroeconomic policies, not of flexible

exchange rates. Flexible exchange rates themselves act to minimize the economic cost of these policies.

The Variability of the Dollar

Variability in foreign exchange rates produces business risk, and while business risk produces opportunity for gain as well as loss, it is probably true that, on average, business prefers less risk to more. Hence the notion that government should fix foreign exchange rates to eliminate this source of business risk.

I could make essentially the same argument for the government acting to fix prices in the stock market, perhaps buying or selling stock to peg the level of the Dow Jones Average. Such an argument would, no doubt, be considered absurd. It is no less absurd for currency prices than it is for stock prices.

The case against fixing foreign exchange rates to eliminate business risk is compelling. First, there is essentially no evidence that foreign exchange rates are subject to destabilizing speculation of the sort that might suggest a role for government to counteract. Indeed, there is ample evidence to suggest the opposite: namely, that it is government intervention that is usually destabilizing. Instead, as with other prices, foreign exchange rates appear to respond to changing fundamentals in the

market. Why should the international trade sector of the economy be shielded from fundamental changes when the rest of us have to live with this uncertainty?

Second, there already exist market mechanisms for business to deal with foreign exchange risk. As this committee is no doubt aware, interbank and exchange markets transfer foreign exchange risk daily on large sums of currency. Indeed, the Chicago Mercantile Exchange has recently established a link with the Singapore International Monetary Exchange to enable this risk to be transferred efficiently even in the middle of the night when U. S. markets are closed. Given the existence of these market mechanisms for handling risk, foreign exchange risk is surely among the easiest business risks to deal with. Indeed, the record shows that U. S. foreign trade as a ratio to Gross National Product has more than doubled since the demise of fixed exchange rates in 1971. It is difficult to argue from these data that business cannot cope with variable exchange rates.

Third, it would be very expensive to fix foreign exchange rates. As an economist I would be remiss in not mentioning first what is perhaps the major cost, albeit a cost that is hidden and hard to quantify, of any price fixing scheme: the misallocation of resources it produces. It goes without saying that the direct cost to the taxpayer would be large, as it generally is with government price fixing schemes. But the

aspect of currency price fixing that is truly frightening is that in order for it to succeed, theory and evidence both suggest that domestic monetary policy would have to be dedicated to this end and coordinated with our trading partners. While I certainly would not want to argue that we have always used wisely the freedom that flexible exchange rates have afforded us in the domestic policy area, to paraphrase William Jennings Bryan, I would much prefer the pitfalls of this freedom to being crucified on a latter- day cross of gold. A fixed exchange rate would not rid us of risk, it would merely shift that risk to other economic variables,such as inflation, deflation or output, where the risk may be harder to quantify and where market mechanisms do not exist to handle risk.

The fixed-exchange rate regime broke down in the early 1970's because we and others found these costs unbearable. With the greater divergence of economic policies and important economic entities in the world today, surely it is unthinkable that fixed exchange rates could be workable now.

Summary

The level and variability of the dollar are not problems in their own right. They are in part messengers bringing us news that all is not quiet on the economic front and in part they are mechanisms for the efficient dealing with that news. If we don't like the news, we should deal with the underlying problems. We should resist trying to deal with the news by shooting the messenger.

Chairman FAUNTROY. Thank you, Dr. Kilcollin. Congressman McCollum and I were reflecting upon the fact it is grossly unfair to bring as able a panel of persons as yourselves who have called up the wisdom of their years of working in a various field, prepare statements like this, and for us to be pressed for time not to be able to adequately question you to assure that we benefit and the American people benefit from your contributions. Please forgive us if we are not able at this moment to seize all the pearls of knowledge you have laid out for us this morning and now into the afternoon.

I am going to start off with some brief questioning, and we will never get to all the very provocative comments and stimulating assessments you have made. Dr. Bryant, as you know, at the current time fiscal policy in this country is in a morass. The size of our structural budget deficit has rendered ineffective any hope of using fiscal policy as a tool to stimulate economic growth. I would like to know whether expecting the Federal Reserve to undertake currency intervention in the absence of sterilization does not relinquish the remainder of the tools in our box to encourage domestic growth? Can this be a wise manner in which to pursue a decline in the value of the dollar?

Mr. BRYANT. Mr. Chairman, I think it would be quite misguided to ask the Federal Reserve, in cooperation with other foreign central banks, to push down the dollar very aggressively in the absence of any change in fiscal policy and the budget deficit. I do not think that is likely to be possible unless the Federal Reserve does that through what has been referred to earlier this morning as unsterilized intervention. A better way to describe unsterilized intervention is as a more expansionary monetary policy.

It may be in the current circumstances that there are arguments for shading domestic monetary policy one way or another—for example, to make it a bit easier. But it seems to me the obligation of the Federal Reserve is to look at all the target variables for the economy and make the best judgment it can on how to set the dials on domestic monetary policy. The things that it should look at certainly include the external position of the United States and the exchange rate.

But as several of you have said, intervention by itself just is not reliable or powerful enough to do that on its own. In other words, it is not really another major tool of economic policy. I am afraid the real choices are to do something about the budget deficit or let the problem accumulate and get still worse. You cannot look to intervention as a way to bail you out.

Chairman FAUNTROY. In my town meetings and with common people around the country, the comment is often made that to them it appears clear that the doubling of our deficit in 4 years was the result of two things: First, the enormous tax breaks in that $750 billion tax package, and second, the enormous increase in military spending, $2.3 trillion in 5 years.

Since that is the case, what prevents us from reversing those two things? Why should we not, if that is a problem, take back some of the tax relief given and reduce the level of military spending? It is rather simplistic, but I am often asked that question. I want you to help me in answering what is—what really you have said to us, I

think—the major problem we are trying to address in the use of these various tools.

Mr. BRYANT. Mr. Chairman, my own personal views are very similar to yours, or the views you described from the public. I do think a tax increase is part of any solution to our current problem. And I would like to see defense expenditures reduced below where they are. But, I am very conscious of the fact there are many other people in the country who have contrary views, either that defense spending should be on a much higher path than I would think would be desirable, and some who would much prefer to take the route of reducing expenditures somewhat or entirely rather than doing it through tax increases.

The views are divergent enough in the Congress and in the country that if each party adheres to their preferred position and will not give to forge a compromise, we will continue with a stalemate. If each side could be more honest about the need for a compromise and everybody would give a little bit, that is the way to go and probably the only politically feasible way to go. I am on your territory. This is not a subject I have any expertise in, needless to say.

Chairman FAUNTROY. Would anyone else want to comment on that?

Mr. FRANKEL. I agree entirely both with personal preferences where to cut and the need to compromise.

Mr. REMPELL. Mr. Chairman, I don't think it is my role to tell the Congress where or how to cut, but I do think I would like to emphasize there is a need to cut. Just as the debt service is becoming an increasing portion of your budget each year now, the failure to cut will only make it more difficult in the future to cut as the debt service starts growing and interest compounds, and you are going to have a real problem down the road if you don't find the right solution now, be it military spending, taxes, nonmilitary spending.

The thing to be careful of is what I call guns and debt service. We used to have a guns and butter policy. It was set back in the late 1960's. I view this policy of the last few years as guns and debt service. The only problem that I see is that debt service, like the butter, will compound rather quickly, and we won't be able to cut back the debt service until we bring the budget down and bring the actual deficit down. That, I believe, is the real danger lurking out over the next 5 years.

Chairman FAUNTROY. Mr. McCollum?

Mr. MCCOLLUM. Thank you, Mr. Chairman.

I would like to make sure that I understand where everybody on this panel stands with regard to your views on the intervention itself, whether it was a mistake, good idea, or not. I know what Dr. Karczmar thinks, I think he stated that pretty clearly in his testimony. I gather from what you said, Dr. Kilcollin, you were not enamored by the intervention and don't feel that gets to the problem. Is that a correct assessment?

Mr. KILCOLLIN. Yes.

Mr. MCCOLLUM. Dr. Bryant, did you favor the intervention we participated in, or how do you feel about it on the bottom line? Is it meaningful?

Mr. BRYANT. I certainly welcome the conversion of the Treasury to a willingness to use intervention. On balance, I believe that that part of the group of five finance ministers meeting was very constructive and deserves to be supported. But I do not feel one can expect too much from intervention, and I am afraid it is implicit in the G-5 communique one might expect too much from it. That is the typical economist answer: "On the one hand, this, on the other hand, that."

Mr. MCCOLLUM. Dr. Frankel, you seem to favor the intervention, but don't think we should expect much from it.

Mr. FRANKEL. It would be better to address the fundamental causes of our problem, which is the budget deficit. But, given how high the dollar had gone by February, I believe it is a reasonable thing to have done—to bring the dollar down by intervention.

Mr. MCCOLLUM. Mr. Rempell, did you favor the intervention?

Mr. REMPELL. I favor the policy shift by the U.S. Treasury which was evidenced by the G-5 accord. The actual intervention I don't think, itself, was a big issue.

Mr. MCCOLLUM. What I want to know, then, gentlemen, if this intervention, which is opposed by two and marginally supported by the other two, and if I am not punning the word "marginally" too much, Mr. Axilrod says the benefits were only marginal in terms of bringing the dollar down, at best. I don't think anyone will dispute the fact it is only marginally effective.

Why did the Treasury do this, why did the Government make this shift now? Was it done for political reasons, to burst the bubble of the moment, the extra thing Dr. Frankel mentioned of the spurt up in the dollar's value that had occurred in the last year, to simply kill the spurt? Was it done to appease our allies? Why was it done? Dr. Frankel, since you had somewhat of an opinion in that area, would you tell us what you think as to why it was done? You worked down there for a while, and they didn't have that view then.

Mr. FRANKEL. That is correct. When I was at the Council of Economic Advisors last year, the relevant Treasury officials opposed all foreign exchange intervention. At the time I didn't really disagree. There did not seem to be too much point, given an unwillingness to change the fundamentals.

I think part of the reason for the shift is that the dollar kept going up after that, and there didn't seem to be anything matching in fundamentals. I imagine also there was a political reason; namely, they looked at what was going on here on the Hill and saw some very dangerous protectionist legislation being talked about, evidently seriously, and they figured they had better do something to bring down the dollar to divert this protectionist pressure and avoid much worse problems.

Mr. MCCOLLUM. Does anybody strenuously disagree with that conclusion as to why they did it? Do you want to add to it, Mr. Rempell?

Mr. REMPELL. Yes; I want to add one thing. I think we have come to a policy impasse. We know about the financial strains that exist in this country, the plight of the farmers, the weak industrial sector. I think we just came to a policy impasse. We got to a point—we have all talked about the budget—we have a fiscal policy

impasse. We have had a rather expansionary monetary policy. Certainly, as Mr. Volcker describes it, it has been accommodative. I think we just got to a point where how do we address these other issues?

And this was just another policy tool that was available, but not before supported by the administration, and where it is believed if you lower the dollar, it will eventually have a stimulatory effect on the economy. It is one tool they were not willing to use before, that may be because of protectionists crying to Congress they were willing to use at this time.

Mr. MCCOLLUM. Dr. Bryant, Dr. Karczmar listed four negative consequences of the dollar's depreciation, and I think basically he thinks it was a mistake to shift in this policy direction at all. Those four I am sure you heard him say, a negative shift in the terms of trade between the United States and its trading partners, increasing difficulties in financing the balance of payments deficits results from this activity of intervention, and the decline of the dollar, the probable rise in inflation that is going to take place, and the actual upward trend in interest rates.

Do you disagree that that would be the result of bringing down the value of the dollar and intervention to do so? I assume you must, or you wouldn't have come to the conclusion you think intervention is OK.

Mr. BRYANT. I do not rest my conclusions a lot on the point about intervention, Mr. Congressman. Some of the negative effects Mr. Karczmar stated would, of course, inevitably accompany a dollar depreciation. There will be a negative change in the terms of trade.

I would welcome that, on balance, partly because it reverses the change in the terms of trade over the last 4 years that is having undesirable effects on the American economy. Will the depreciation of the dollar increase inflation in the United States? Definitely.

But you need to remember in the period 1980 to early 1985, when the dollar appreciated by some 80 to 90 percent, we benefitted. We had some disinflation gains, so to speak, at the expense of the rest of the world. We managed to get our inflation rate down faster because the dollar was appreciating. Now, if we remedy the distortions in the economy by having the dollar fall, we have to give back some of those disinflation gains. That is a cost that will inevitably be borne if we reduce the distortions in the economy.

In several other ways, there is a fundamental difference between Mr. Karczmar and myself in our views about the balance of payments and its relationships to the economy.

Mr. MCCOLLUM. Let me pursue one other thing with you while we are there. I doubt if any of the panel, including yourselves, would disagree at least a key factor in our problem with balance of trade today is the question of our foreign trading partners not being vigorous enough in their own economies and not being strong. Obviously Latin America debt problems are there, and certainly in Europe we have had problems with their doing things that would be competitive in the sense of producing a climate that would involve a greater desire to import our products.

To what degree do you think that that is a factor vis-a-vis the value of the dollar, and to what degree do you think this is not as important as our bringing out our deficits and our bringing down the value of the dollar?

Mr. BRYANT. I think there is a lot of blame to go around in the world. I do not think that the German macroeconomic policies or Japanese macroeconomic policies or British macroeconomic policies have been everything they might be. Some of the big appreciation of the dollar in the last 4 years up to February can be explained by those foreign policies.

But I do not think those forces were as important as the distortions in our fiscal-monetary mix in the United States. As I said briefly in my remarks, if we could change our policy mix, make decisive progress on the budget deficit, allowing the Federal Reserve to be less contractionary than it would otherwise be, that would create situations where it would be easier for foreign countries to adjust their policies.

Mr. MCCOLLUM. Aren't there fundamentals those other countries need to do? In the Latin American situation, that is partly the reason we have the question of our monetary fund effort to try to get—IMF trying to get something done to change those fundamentals, isn't it?

Mr. BRYANT. Yes; there are many adjustments other countries need to make. But it is an old trick to look at other countries and judge them by their actions while we judge ourselves by our motives. We can do more about our own policies than Brazil's policies or Japan's policies. Indeed, our fiscal situation is probably just as outrageous as the Brazilians have been over the last 3 or 4 years.

I am not excusing the other countries in any sense. If they should correct their policies, that would help us out and help correct the imbalance.

Mr. MCCOLLUM. Dr. Karczmar, your testimony is quite intriguing and your analysis I think I understand, I followed it, both read it and listened to it. At no point in time do I see you as some of the others, being terribly concerned about our own deficits. Perhaps you explain that in the first part of your analysis. I am wondering if despite the fact you look at things a little differently you meant to overlook that.

Are you concerned, should we be concerned with the fiscal side here? I kind of suspect you are concerned about it even though you didn't say anything about it. Would you comment on that, please?

Mr. KARCZMAR. Yes; you are absolutely right, Congressman McCollum. The fact that I did mention that I see no correlation between the budget deficit and interest rates, and for that matter with the value of the dollar, doesn't mean at all that I am not concerned about the budget deficit. I am very much in favor of cutting the budget deficit. The only thing I was trying to convey was that one should not expect that if we manage to cut the budget deficit, which we all want, this would automatically reduce the value of the dollar.

[The following supplemental statement was submitted for the record by Mr. Karczmar:]

On the contrary, it could strengthen the dollar. It is no accident that, historically, low-deficit countries have had strong rather than weak currencies.

Now, I would go even further. If a dollar's fall were a sure result of cutting the budget deficit, then I would not be in favor of cutting it. Because, as I mentioned in my testimony, a strong currency is a mixed blessing, but in my view the strong dollar was, on balance good for the American economy, even though some sections have suffered.

Mr. MCCOLLUM. Why would you support cutting the budget deficit, to expand the economy, get more dollars out there? Why should we care if we have a big deficit or not?

Mr. KARCZMAR. It is a reflection of an imbalance in the economy. I wouldn't worry much about the budget deficit if we were at the beginning of the business cycle, if we were coming just out of the recession. It would have been a natural and normal thing.

But we are now 3 years into a recovery, our business cycle is becoming more and more mature. And under such situation, having a large budget deficit is not a desirable thing.

On the other hand, however, I would like to draw your attention that one cannot measure the budget deficit by its sheer size in dollar terms alone. Sure $200 billion is a huge amount, but you have to relate it to the size of the economy, and this is a huge economy.

If you take also into consideration that we have surpluses in State and local budgets, and if you take into account the consolidated budget, and this is the only way you can evaluate the economic impact of the budget deficit, then you will find that the size of the consolidated deficit relative to the size of the economy is not that large.

We are more or less in the ball park of other major low-deficit countries in relative terms.

But, as I said, I am far from neglecting the issue. I would like to see the budget deficit reduced, mainly because the cost of interest we are paying is increasing sharply. That is something which we have to cope with.

Mr. MCCOLLUM. Thank you very much.

Thank you, Mr. Chairman.

Chairman FAUNTROY. Thank you, Mr. McCollum.

One question stimulated by Dr. Kilcollin's testimony is, if the United States were to subscribe in the future to a fixed exchange rate system, what would be the impact in your estimation on domestic interest rates, on domestic inflation, and the impact on the deficit, and what would be the impact on the Federal deficit financing if we had a fixed interest rate system?

Mr. KILCOLLIN. I really wouldn't have any firm estimates on that effect. My point there was—if we were ready to commit ourselves to a fixed exchange rate regime, I believe that necessarily restricts our ability to conduct monetary policy in a way we might otherwise want to do it.

For instance, from our discussion here presumably we would be talking about driving the dollar down, and I think most people here would agree if you were to try to do that, a sterilized intervention really would not be effective, we would be talking about an unsterilized intervention, which is essentially an expansive monetary policy.

So I think we would then be saddled with having to conduct our monetary policy in a way that would fix exchange rates and we would then be tied into the monetary policy of other countries as well. And I believe that cost would be a principal cost of fixed exchange rates, just the loss of our freedom to conduct our domestic policies in a way that we feel is most advantageous to us.

Chairman FAUNTROY. What effect do you think it would have upon American exporters such as farmers, who now depend pretty much upon the Chicago Board of Trade for risk management?

Mr. KILCOLLIN. Well, in terms of risk management, I think insofar as we could fix it, and I wouldn't really want to suggest that we would want to or even could fix exchange rates, but, if we could, obviously that would get rid of one source of risk that would be faced, in the international trading sector.

But I do think that other sources of risk would then be introduced as well. So we wouldn't be getting rid of risk from the point of view of the economy, we would just be shifting it from one sector to another. It is difficult to even quantify where that risk would show up. Certainly the likely sectors would be inflation or in changes in output.

Chairman FAUNTROY. Dr. Frankel, you estimated that if the dollar fell suddenly 20 percent, that the interest rates would rise by as much as 300 bases points over the next 2 years. I think you pointed out that the dollar has fallen 15 percent since September. What is that likely to mean for domestic interest rates? I guess more important, what does it portend for the current economic recovery and therefore, for employment and for housing, for example?

Mr. FRANKEL. Mr. Chairman, my statement about the likely effects of a 20-percent decline in the dollar refers to a decline in the dollar that would come about as a sudden drying up of the capital inflow, a loss of confidence in the United States or for some reason foreigners stop putting money in the United States. That is the source of decline of the dollar I predicted would raise interest rates.

What we have seen so far this year has been somewhat different. I think the decline of the dollar that we have seen this year is in part a response to perceptions of an easier monetary policy which, at least in the short run, has the reverse implications for interest rates, driving them down before inflation becomes a factor again.

Chairman FAUNTROY. How might the Federal Reserve expect to handle that? Should it or should it tighten reserves? Should it lower the discount rate? What would you advise?

Mr. FRANKEL. I assume we are talking about this exogenous drying up of capital causing interest rates to rise. If this happens, the middle course for the Fed that I suggest in my testimony that they probably would follow is also I think the one that is appropriate. If the Fed were to seek to prevent interest rates from rising at all, inflation might reaccelerate sharply. On the other hand, if they were to seek to prevent prices from rising at all—especially if they are looking at the Consumer Price Index which includes import prices directly—if they were to seek to prevent that from rising, interest rates would rise by more than I said in my scenario, perhaps enough to cause a recession.

The middle course I predicted is also the one that seems to me is sensible to keep GNP on track. It might require some slight tightening in terms of reserves, but it might not. It might just happen automatically.

Chairman FAUNTROY. Mr. Rempell, you raise the question of globalization of world bond markets. Has that in your view, narrowed the options of the Federal Reserve? How is that reflected in debt financing operations and policies as you see them from a primary dealer's perspective?

Mr. REMPELL. I think to date, because we haven't had as global a marketplace as I envisioned, it has actually benefited the United States. We have become—open markets became a place where people like to store their capital and store their reserves, particularly when the environment here seems right to them, where it is low inflation, bond markets look very attractive. They offer size, they offer liquidity, they allow them to get in and out. I believe a lot of that benefit now can inure to other countries as the markets grow and change, and the United States won't have as easy a lock on the world's capital nor necessarily on the capital of domestically based investors as well.

We have to have—we will be penalized more for incorrect economic policies. I think we have had a good benefit. I think now the pendulum is swinging.

Chairman FAUNTROY. It seems to me that we must assess the cost benefits of what we are doing. Is the issue of the too strong dollar fundamentally an issue of how the cost benefits of the current exchange rates and value of the dollar are distributed? Domestic costs we have seen, weaker performance in the exports, dependent on import-sensitive industries where all the benefits of the strong dollar are of course the effects on foreign capital and interest rates, and internal economic growth. How can we assess whether the dollar is too strong? Can the assessment be made simply on the basis of the internal costs and benefits, or is a more international focus essential? Help us, please.

Mr. FRANKEL. I think there is no question the dollar is too strong. All you have to do is look at the effects on the trade deficit. I found some of Mr. Karczmar's statements quite incredible.

I disagreed with a number of points, such as the lack of a relationship between budget deficits and interest rates—and it is of course real interest rates that are relevant, not nominal. But I find particularly incredible his statement as to the lack of an effect of the dollar on the trade balance. There is nothing more well established empirically in international economics than the relationship between the exchange rate and trade balance. If one thinks there is no effect, one has only to ask Caterpillar Tractor or the farmers, or other sectors of the economy losing here.

If we take the budget deficit as given, and most of us up here have agreed that it is the fundamental cause of the trade problem, then the situation is quite different. Then you can argue it makes sense the dollar is as strong as it is.

In essence the budget is crowding out the whole private economy. If we are going to crowd out construction and interest-sensitive sectors of the economy, then perhaps we should crowd out the trade-sensitive sectors as well. It is just a question of distribution of the

crowding out among different sectors, and it is hard to say more of it should be borne by the construction industry and less by the farmers, or the auto industry. That is a very difficult judgment, one I don't think any of us would want to make, and I guess Congress will have to make.

Mr. BRYANT. Let me add to that. I agree with what Jeff said, but it is not merely the distributional costs within the United States, important though those are. The policy in the United States and the strong dollar have adversely affected the rest of the world in important ways.

The most obvious example is developing countries with large debts where their interest rates rose very sharply. That was undoubtedly one of the major contributing factors to their problem.

The high interest rate certainly was a difficulty to them. If you step back a bit and ask yourself whether you can justify the richest country in the world running a very large current acccunt deficit pulling in savings, real resources from the rest of the world, I must say that is backward from what my norms say is appropriate.

Although the costs are most important to the U.S. economy, and let's not forget that the rest of the world has a role here, too.

Chairman FAUNTROY. Dr. Kilcollin.

Mr. KILCOLLIN. I feel very uncomfortable trying to determine whether a dollar loss in one sector is worth it for a dollar gained in another sector, and I wouldn't want to address that. I do think as an economist that there is something that can be said about the efficiency effects of a price mechanism. The policies that we and others have been pursuing have led to certain changes in the economy, and the adjustment of the price mechanism from an efficiency point of view has been one that has minimized disruption that has ensued from that.

Obviously in the case of the dollar, had we stifled domestic investment or had we been able to increase domestic savings, then we wouldn't have needed the importation of capital, and I think we would not have had the trade deficits that we have. But, I would think just from the operations of the market that the trade deficit really was the most efficient way of handling that imbalance. Rather than stifling domestic investment, for example, I wouldn't want to go beyond that to say that the damage that has been done to our exporters can be somehow compared in some equity principle with, let's say, the benefit that has been done in the construction industry as a result of lower interest rates.

I don't know how to do that.

Chairman FAUNTROY. Mr. Karczmar.

Mr. KARCZMAR. Yes; I understand that what you are really asking us is to take a position whether we consider the dollar as overvalued, although you put it as being too strong. I would understand it as overvalued. This is a very popular notion. Many economists, and some of them represented here at this table, would consider the dollar as highly overvalued. And there are numbers spelled out, 20 percent, 30 percent, 40 percent overvalued.

Well, even if one could find a proper base sometime in the past where the dollar was not overvalued, where we did have an equilibrium, which is very difficult, to me it is a rather problematical concept because the issue of overvaluation can be dealt with only if

you consider the dollar as U.S. domestic currency functioning in the trade sphere only, and nothing else.

In such a case, based on certain calculations, based on domestic purchasing power of various currencies, you could probably say the dollar in trading terms is somewhat overvalued.

I don't know by how much, but it probably is. But for me this is not very relevant because the dollar is not just a U.S. domestic currency. It is not just a trading currency. A dollar is an international currency. It has important international functions. It is the main investment currency, it is the main reserve currency, and in terms of the magnitude, the size of capital flows worldwide is much greater than the size of trade flow.

So for me the concept of over or under valuation of the dollar is of very little relevance. After all, it is the market which determines the value of a currency.

So, in conclusion, I am not able to answer this question whether I consider the dollar as too strong, or in other words as overvalued.

Chairman FAUNTROY. Mr. Rempell.

Mr. REMPELL. I think in addressing that question we got to ask for whom? Just like when interest rates go up very sharply as we saw in the early 1980's, those sectors of the economy that are interest-sensitive such as autos and housing, for them it was severe. For those people in real estate development gaining from the inflation, it was not as severe.

In terms of the dollar, I would say who thinks it is too strong, for the nonsupporter, non-United States, they think it is fine. For the person in the United States trying to export their goods, it is too strong. For the Latin American debtor who owes dollar interest payments, it is too strong. It is a question of no matter what policy you have, there are people going to benefit from it, people going to be hurt by it.

I think we just have to recognize which sectors stand to gain, which sectors stand to lose, and it becomes a judgment.

Chairman FAUNTROY. Gentlemen, let me thank each of you for your contribution to this hearing. I cannot tell you how much we appreciate the effort that you have made to organize your thoughts and present them in a fashion that would be helpful to us, perhaps this committee will get more clarity and give leadership to the Congress. Unfortunately we are far over the time we had planned to be here on this hearing, and this panel, but you can attribute that to the careful work that you have done and what you have stimulated among us.

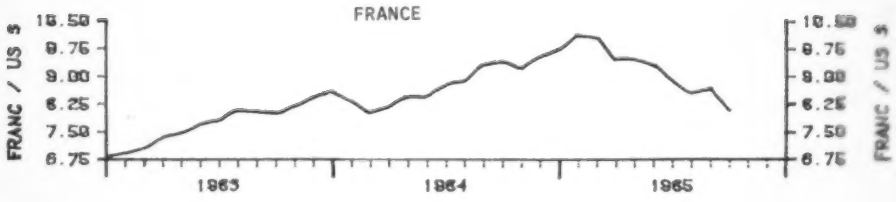
Thank you so very much.

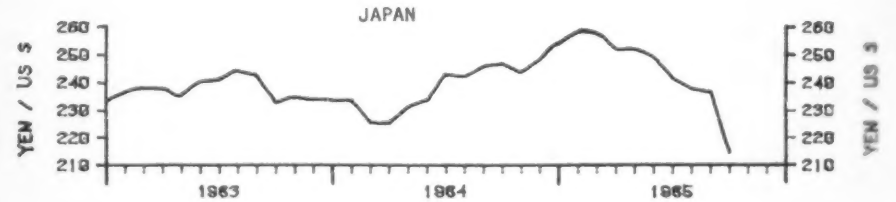
With that, the hearing is called to a close.

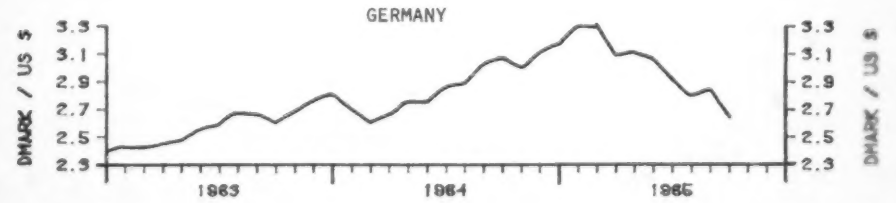
[Whereupon, at 1:15 p.m., the subcommittee was adjourned.]

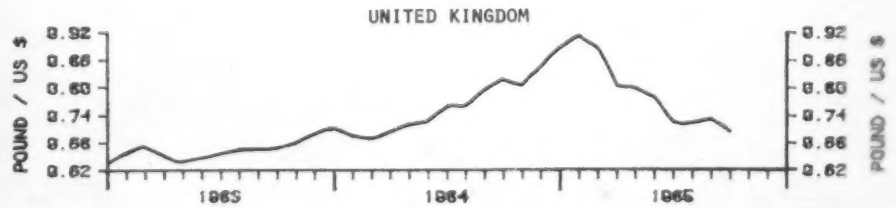
APPENDIX

RATES OF EXCHANGE





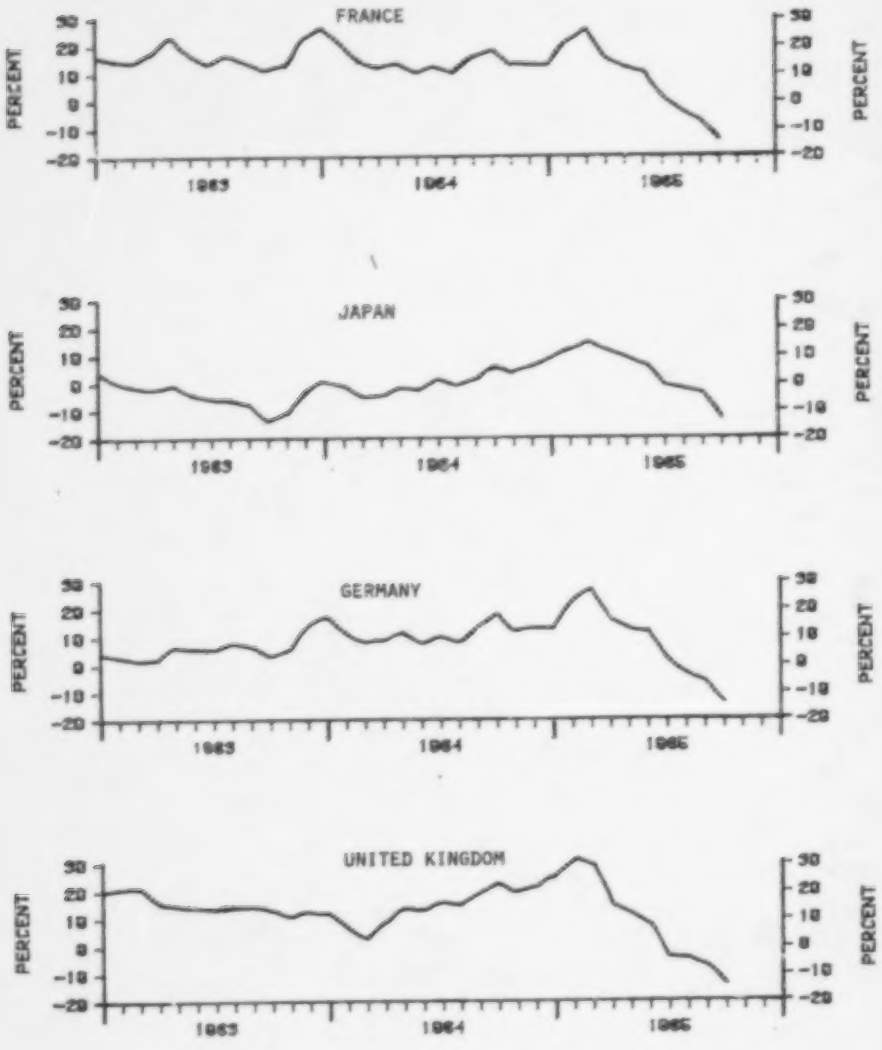




THRU OCTOBER 1985

PERCENT CHANGE IN RATES OF EXCHANGE

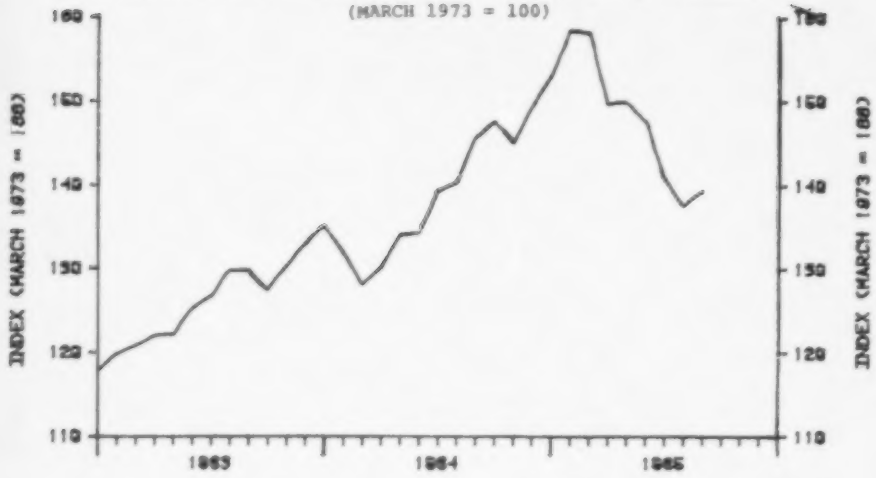
(FROM SAME MONTH 1 YEAR AGO)

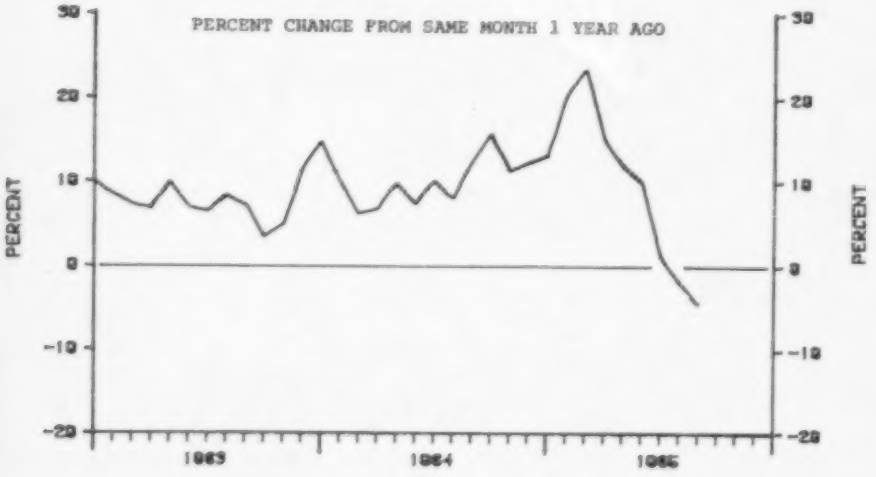


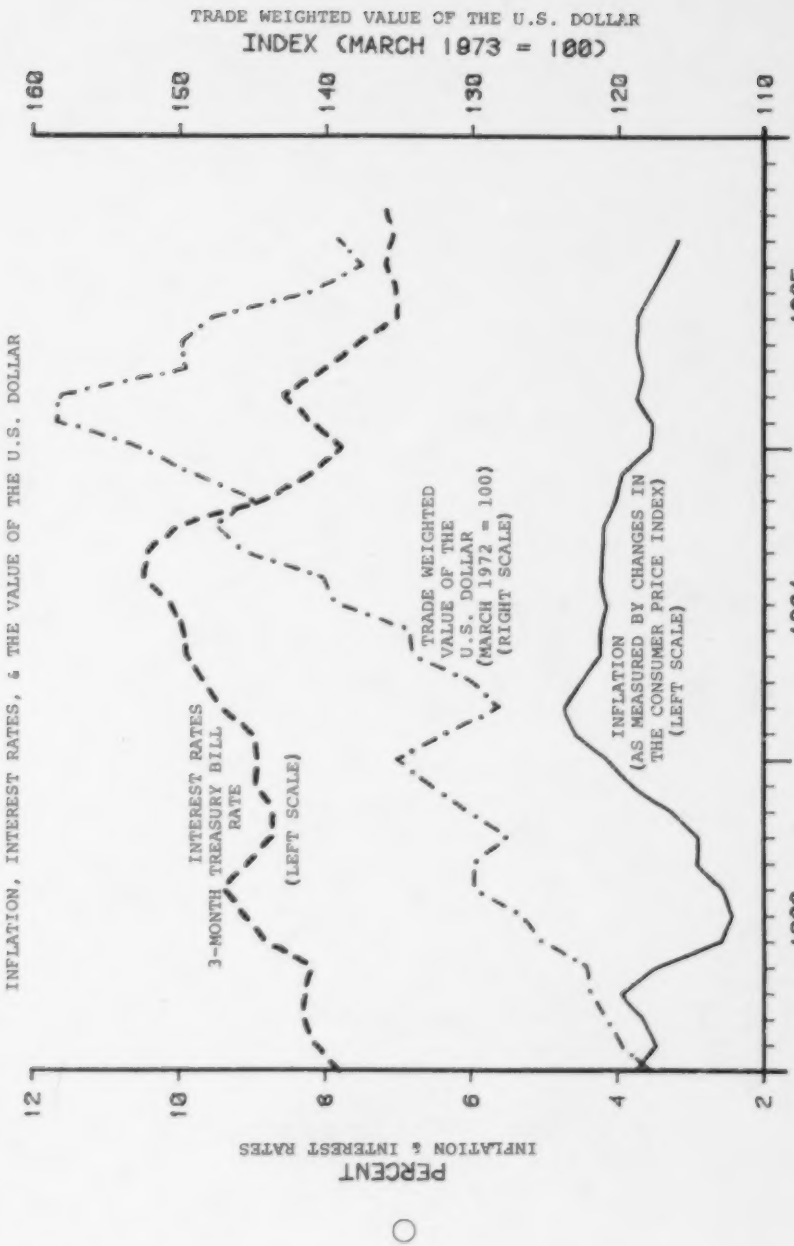
THRU OCTOBER 1985

TRADE WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR

(MARCH 1973 = 100)






INFLATION, INTEREST RATES, & THE VALUE OF THE U.S. DOLLAR
TRADE WEIGHTED VALUE OF THE U.S. DOLLAR
INDEX (MARCH 1973 = 100)
160
150
140
130
120
110
INTEREST RATES
3-MONTH TREASURY BILL RATE
(LEFT SCALE)
TRADE WEIGHTED VALUE OF THE U.S. DOLLAR (MARCH 1972 = 100) (RIGHT SCALE)
INFLATION (AS MEASURED BY CHANGES IN THE CONSUMER PRICE INDEX) (LEFT SCALE)
1983
1984
1985
12
10
8
6
4
2
PERCENT
INFLATION & INTEREST RATES